DOJ OVERSIGHT: *U.S.* v. *A.T. & T.*
(The Effect on Local Rates)

HEARING

BEFORE THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

THE DEPARTMENT OF JUSTICE OVERSIGHT OF THE UNITED STATES
VERSUS AMERICAN TELEPHONE AND TELEGRAPH LAWSUIT

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DOJ OVERSIGHT: *U.S.* v. *AT&T*
(The Effect on Local Rates)

THURSDAY, MARCH 25, 1982

U.S. SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The committee met, pursuant to notice, at 9:36 a.m., in room 412, Russell Senate Office Building, Hon. Strom Thurmond (chairman of the committee) presiding.

Present: Senators Thurmond, Specter, Metzenbaum, and Leahy.

Staff present: Marcy J. K. Tiffany, chief economist and antitrust counsel; and Bruce Cohen, chief counsel and staff director, Subcommittee on Juvenile Justice.

OPENING STATEMENT OF SENATOR ARLEN SPECTER

Senator SPECTER. Good morning, ladies and gentlemen. We will convene this hearing of the Judiciary Committee on the AT&T divestiture issue, with our focus today being the effect on local rates.

Our first panel is from the Federal Communications Commission. We have this morning the Honorable Mark S. Fowler, Chairman of the Federal Communications Commission, and the Honorable Joseph R. Fogarty, Commissioner of the FCC. Welcome, gentlemen. Would you introduce those who are accompanying you here, please?

STATEMENT OF HON. MARK S. FOWLER, CHAIRMAN, FEDERAL COMMUNICATIONS COMMISSION, ACCOMPANIED BY HON. JOSEPH R. FOGARTY, COMMISSIONER, FCC; GARY EPSTEIN, CHIEF, COMMON CARRIER BUREAU, FCC; AND BURT HALPERIN, CHIEF, POLICY DIVISION, COMMON CARRIER BUREAU, FCC

Chairman FOWLER. Mr. Chairman, to my right is Gary Epstein, Chief of the Common Carrier Bureau of the FCC, and Burt Halperin, who is Chief of the Policy Division of the Common Carrier Bureau.

Senator SPECTER. We welcome you here, gentlemen. Without any formalities, we will proceed to hear your testimony. Any written statement which you have will be made a part of the record. Our practice is, as you doubtless know, to request that you summarize, leaving the maximum time possible for questions.

Chairman **Fowler**. I have a brief statement here, sir. I have a longer statement which I have submitted for the record.

Senator **Specter**. Thank you. It will be inserted, without objection.

Chairman **Fowler**. Thank you, Mr. Chairman, for extending this invitation to testify about the proposed settlement of the AT&T/Department of Justice antitrust proceeding and about whether there is a need for legislation to amend the Communications Act of 1934 at present. My testimony this morning will focus on the effect, if any, of this proposed settlement on local telephone rates.

During the past 2 months the FCC has carefully analyzed the proposed settlement to determine how its terms mesh with our procompetitive stance and the public interest mandate under the Communications Act of 1934. We also held an en banc meeting yesterday to solicit the views of the interested parties on this subject. We shall participate in the Tunney Act proceedings and shall file an amicus brief with Judge Greene.

The effect of the proposed decree on local telephone service rates has been the subject of much speculation. Local rate levels involve complex interrelationships. They bring into play the arcane subject of jurisdictional separations. And, of course, they have significant impact on most American consumers' pocketbooks. It is not surprising, therefore, that such an important and difficult-to-understand subject should give rise to misconceptions. I hope to dispel two such misconceptions this morning.

The first is that the consent decree will cause a precipitous increase in local rates. The second is that the FCC is somehow irresponsibly causing increases in local rates.

The Common Carrier Bureau staff's preliminary analysis of the effects of the proposed decree indicates that the local rate question, while an important issue, is not critically affected by the proposed decree. It is other pressures, such as inflation, increased depreciation rates, terminal equipment deregulation, changes in separations and the expensing of station connections that are chiefly involved.

A first and critical cause of increased local rates is the gnawing inflation we all face. As the cost of debt and equity capital rises and the cost of labor increases, rates eventually must follow. A simple fact of life is that a 10-percent inflationary increase in costs compounded yearly for 10 years by itself will result in approximately a 160-percent cost increase.

A second important factor affecting local rates is the Commission's significant modifications in its depreciation policies. All accounting measures are important, but in a capital-intensive industry like telecommunications the measure of depreciation becomes even more critical.

What we had under earlier depreciation procedures was a significant instance of underaccrual. As a result, the recovery of some costs incurred by present customers was deferred for payment by future customers. We believe our new depreciation policies will improve the technical and economic resilience of the industry and correct the distribution of costs between present and future ratepayers.

The third upward force on the cost of local service is deregulation of terminal or customer premises equipment, as part of our *Computer II* decision. Competition and technological development in terminal equipment markets, especially in the business market, is burgeoning. This boom in the terminal equipment market makes deregulation of CPE necessary. But deregulation of CPE also necessitates its removal from the separations process. The Popenoe plan for removing CPE from separations, recommended by the Joint Board and adopted by the Commission on February 24, 1982, mitigates the effect of CPE removal on local rates.

Our major goal in the Joint Board proceeding is to develop procedures that provide a more acceptable level of cost allocation to services in each jurisdiction so that more efficient use can be made of the telephone network. Changes in the separations process, even if they are tempered by measures to continue socially desirable subsidies, may also create upward pressure on local rates.

Finally, about a year ago the Commission voted to mandate the expensing of station connections, and this expensing also raises local rates. Station connections are the wires from your house to the telephone pole outside, a big-ticket item in telecommunications service. Prior to this decision, station connections had been capitalized.

Current and anticipated local telephone rate increases are, then, products of inflation, the technological revolution reshaping telecommunications, competition, and of responsible, responsive Commission policy changes. In making policy changes, we have repeatedly underscored our concern about local rates and have implemented our policies in a manner designed to avoid massive disruption or dramatic rate increases.

The proposed consent decree will not necessarily produce any substantial effects on local rates if the divestiture is accomplished through a fair implementation plan. Of course, a reorganization plan which is not properly conceived could affect the divested BOC's in a manner that increases their capital costs. This effect could be reflected both in local exchange rates and in access charges. The FCC intends to remain closely involved in the proposed divestiture process to insure that these eventualities do not come to pass.

The mechanism of the proposed consent decree for compensating the BOC's for their participation in interstate calling is one of access tariffs rather than the present AT&T/Bell operating company division of revenues contractual procedures. I do not believe that such a change of the mechanism, from one of private contract to one of tariff, would necessarily change current results. Access charges for interstate services under existing law will reflect the exchange plant costs which are allocated to the interstate jurisdiction under the separations manual. Such allocation is within the jurisdiction of the Commission under the Communications Act of 1934. Local exchange rates will continue to reflect the remaining costs allocated to the intrastate jurisdiction.

To sum up, claims that the consent decree or the FCC will cause increases in local rates are oversimplifications at best. In fact, these increases are the result of multiple factors, addressed above. The proposed decree does, however, sharpen our focus on critical policy issues. And it makes watchfulness by the Congress and the FCC imperative to insure that a fair capitalization plan is presented.

I shall now address the other subject of this hearing, Mr. Chairman, whether legislation to amend the Communications Act of 1934 is needed. My position is that a comprehensive revision would be untimely until after Judge Greene has completed proceedings under the Tunney Act. I do believe that some changes to the 1934 act could not only achieve broad-based support but also would largely ameliorate residual problems and new ambiguities which might be introduced by the decree. Short-form legislation which I recommend would include the following provisions:

First, explicit authority for the FCC to exempt carriers from the title II provisions of the act and to forbear from regulation; second, a statutory presumption that the public interest favors competition rather than regulated monopoly; third, clarification that the FCC retains authority over the separated BOC's to prescribe jurisdictional separations, accounting requirements, and depreciation rates; fourth, FCC jurisdiction over all interexchange services, including intrastate toll historically subject to State jurisdiction. The arguments made in favor of such a transfer in earlier congressional debates apply with even greater force in the environment of the decree, with its AT&T/BOC split generally founded upon an interexchange/exchange activity split.

My foremost duty as Chairman of the FCC is to protect the public interest. It is from this vantage point that I, together with my fellow Commissioners, have directed analysis of the proposed consent decree. Its potential repercussions in the dynamic telecommunications industry and in related ones, are undoubtedly massive. To most sharply appraise them, I have tried to distinguish fact from misconception. And one fact is that no one cause, including the decree, will precipitate projected higher local telephone rates.

I thank you very much. I believe that Commissioner Fogarty, Mr. Chairman, has a statement.

Senator SPECTER. Mr. Fogarty, we are pleased to hear from you at this time.

Mr. FOGARTY. Thank you very much, Mr. Chairman. I, too, appreciate the opportunity to appear before your committee and to share with you my views with respect to the implications and perhaps some problems that will arise from the entry of this modification to the AT&T consent decree.

I think it is an understatement, Mr. Chairman, to note that the proposed consent decree is of momentous significance for this Nation's telecommunications policy, but certainly it is no overstatement to suggest that the new decree raises some very serious questions regarding the FCC's statutory obligations under the Communications Act of 1934.

I circulated earlier to the Commission a memorandum in which I set forth my views with respect to the Commission's obligations under the 1934 act with regard to the consent decree. I ask that that also be made a part of this record, Mr. Chairman.

Senator SPECTER. Yes, it shall be, without objection.

[Material referred to follows:]

UNITED STATES GOVERNMENT
memorandum

DATE: January 21, 1982

EPLY TO ATTN OF: Commissioner Fogarty

UBJECT: AT&T/DoJ Antitrust Proceedings

TO: All Commissioners
Chief, Common Carrier Bureau
General Counsel

The recent "settlement" reached between American Telephone and Telegraph Company (AT&T) and the Department of Justice (DoJ) is of momentous significance for this nation's telecommunications policy in general and in particular, for this Commission's responsibilities and prerogatives concerning that policy. While I am aware that our Common Carrier Bureau is moving quickly to assess this significance and to prepare analysis and recommendations for possible Commission action, I want to share with you some initial thoughts on what I see as certain core issues and concerns.

At the outset, I want to emphasize that while AT&T and DoJ may have reached a reasonable and proper private accord under the antitrust laws, such accord, with or without judicial approval, cannot oust, supplant or modify this Commission's mandate, authority, and jurisdiction under the Communications Act of 1934. Indeed, in cases of irreconcilable conflict it is the antitrust law which must yield to this Commission's broader regulatory jurisdiction. Otter Tail Power Co. v. U.S., 410 U.S. 366 (1973). The reason for the primacy of our regulatory jurisdiction is plain: the Communications Act requires the FCC to base its actions on findings made in accordance with the statutory standard of the "public interest, convenience, and necessity;" by contrast, the antitrust laws look solely to competition as the safeguard of the public interest. Although competition is a component part of our regulatory standard, it is not the whole. This Commission's mandate is not merely to further competition or simply to balance equities among competitors, but rather to determine how best to provide telecommunications service to the public. FCC v. RCA Communications, Inc., 346 U.S. 86 (1953); Hawaiian Telephone Co. v. FCC, 498 F.2d 771 (1974). As the Supreme Court has stated:

> The very fact that Congress has seen fit to enter into the comprehensive regulation of communications embodied in the Federal Communications Act of 1934 contradicts the notion that national policy unqualifiedly favors competition in telecommunications.
>
> . . . .
>
> What may substantially lessen competition in those areas where competition is the main reliance for regulation of the market cannot be automatically transplanted to areas in which active regulation is entrusted to an administrative agency; . . . what competition is and should be in such areas must be read in light of the special considerations that have influenced Congress to make specific provision for the particular industry.

FCC v. RCA Communications, Inc., 346 U.S. at 93, 98.

It is precisely because the standard of the antitrust laws differs from this Commission's statutory mandate that the judicial setting of the new consent decree between AT&T and DoJ raises special considerations of the proper relationship between the FCC and the courts. In particular, the possibility of inconsistent or even contradictory decisions and directions affecting members of the regulated industry must be closely examined from the standpoint of the congressional delegation to this Commission of the primary jurisdiction over telecommunications policy. Principles of judicial and administrative agency economy may also be concerned.

These general comments should not be read as indicating any preconceived views on my part as to the legal or policy merits of the new antitrust consent decree agreed to by AT&T or its consistency with the FCC's mandate and authority. I am aware that the law favors an analysis which seeks to accommodate both regulatory and antitrust regimes. *Silver v. New York Stock Exchange*, 373 U.S. 341, 357 (1963). I also believe that the larger public interest may be well served by the parties' private settlement of their differences under the antitrust laws. However, I am equally--indeed, primarily--concerned that the Commission take pains to ensure that its existing congressional mandate and regulatory jurisdiction and authority are respected. I am confident that our staff is undertaking its analysis and preparation of recommendations with this perspective firmly in mind.

Turning to specifics, it appears to me that all the major aspects of the new consent decree may involve the FCC's jurisdiction and authority. In making this preliminary assessment, I have drawn heavily on the excellent *amicus curiae* memorandum filed by the Commission in 1975 in the U.S. District Court for the District of Columbia which has been hearing the AT&T-DoJ antitrust suit. We are fortunate that our jurisdictional views and concerns were entered early on the record in this judicial proceeding.*

(1) Industry Market Structure

The salient feature of the new consent decree proposed by the AT&T-DoJ accord is the divestiture by AT&T of its 22 Bell Operating Companies (BOCs). The potential impact of this proposal on our nation's telecommunications network and the services provided through it may be benign or cataclysmic, but such a dramatic change in telephone industry market structure clearly warrants this Commission's review and comment. The apparent intent and effect of the new decree is to separate completely the BOCs' "natural monopoly" local exchange services from all other AT&T operations, as well as to preclude BOC provision of CPE and "information services" and to limit the BOCs to providing only local exchange service and exchange access. The severance of end-to-end Bell System facilities and service raises questions concerning the continued adequacy of telecommunications network capacity and the continuity of network planning. The consistency of the new decree with the policy directions and the dates of implementation established by the Commission in *Computer Inquiry II* must also be considered. The prohibition on BOC provision of "information services" impacts the Commission's pending inquiry on cable television/telephone company cross-ownership. The Commission's *Cellular Radio* decision may also be affected by the new decree.*

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* It should be noted that the Commission's *SBS* authorization order cited this *amicus curiae* memorandum as setting out "those limited areas where we believe the antitrust laws have been implicitly repealed by the passage of the Communications Act," 62 FCC 2d 997, 1071 n.133 (1977), and included the memorandum as Appendix A to the *SBS* decision at 62 FCC 2d 1102-32. The memorandum thus enjoys a full imprimatur of Commission action and precedent and does not merely represent the litigation views and positions of its counsel.

While the Commission's *amicus* memorandum observed that FCC authority with respect to telephone industry structure is "limited" under the Communications Act, it also stated that:

> The Court should not alter the basic industry structure until the agency has had an opportunity to study the effects of such a change on the provision of communications services. Factual issues relevant to the benefits and drawbacks of possible structural changes should be referred to the agency for its views, for the Communications Act clearly made the FCC the primary architect of communications policy. Structural changes in the industry, of course, could have a significant effect on policy. We believe the doctrine of primary jurisdiction applies here as in other areas as the appropriate means of accommodating antitrust policy with the agency's regulation of communications. In any event, the FCC should be consulted before any possible remedies are seriously contemplated, either by further participation as *amicus curiae* or by exercise of the agency's primary jurisdiction as fact-finder in communications matters of national importance.

68 FCC 2d at 1118. The Commission's views on the industry restructuring proposed by the new decree and its impact on this agency's developing telecommunications policies are critical and should be heard.

(2) Section 214 Authority

Directly related to the foregoing matters of industry structure is the question of whether this Commission's Section 214 approval is required to effectuate the BOC divestiture. Based on recent Commission precedent, I believe it is possible for the Commission to assert such authority.

In its 1979 *GTE-Telenet Merger* decision, the Commission set forth a broad and expansive interpretation of the purpose and reach of its Section 214 authority. In affirming on reconsideration its holding that GTE and Telenet's parent corporation were required to secure prior FCC approval of GTE's proposed acquisition of the parent's stock by filing an application pursuant to Section 214, the Commission reasoned that:

> Section 214 provides the basic framework within which this Commission controls market entry and exit and imposes conditions upon the use of common carrier facilities in exercise of our broad statutory mandate to "regulat[e] interstate and foreign commerce in communication by wire and radio." [citing Section 1 of the Communications Act]

72 FCC 2d 91, 93. GTE had advanced a "contrary position" which relied on a "kind of corporate line drawing" to urge that "the various parents and subsidiaries within the GTE system" be regarded "as completely separate corporations within the meaning of Section 214." *Id.* at 95-96. Thus GTE submitted that it was not a "carrier" under the section because it "did not provide common carrier services itself but only through separate subsidiaries," and that it was not acquiring Telenet's facilities but only the ownership of the corporation itself" and would "not operate Telenet's facilities because Telenet will remain a separate corporation." *Id.* at 96. Rejecting these arguments as "overly technical," the Commission countered that:

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* These are not the only Commission proceedings involved. Practically every major Common Carrier Docket will be affected.

> As the regulatory agency responsible for the oversight of interstate communications this Commission must be guided by practical considerations and the consequences attendant upon corporate ownership, control, etc. It is not free to "disregard [the] . . . actualities in such intercorporate relations. . .," . . . and to rely instead upon legal fictions.

Id. (Citation omitted). The Commission also observed that "the issues of whether a transaction will entail a change in operation or will result in an impairment of the adequacy or quality of service are issues of fact, appropriately decided by this Commission." *Id*. at 100-01.

The Section 214 result and reasoning of *GTE-Telenet* with respect to entry by acquisition may apply with equal force to exit by divestiture. While the proposed consent decree's terminology of "exchange" and "interexchange" is not particularly edifying on the point, it appears clear that the BOC divestiture contemplates severance from AT&T and assumption of control by the BOCs of interstate, as well as intrastate facilities--i.e., "lines" within the meaning of Section 214. It also appears that AT&T may be assuming control of facilities previously operated and controlled by the BOCs. Regardless of the technical corporate stock structuring of the proposed BOC divestiture, we cannot "disregard actualities or rely on legal fictions." Most importantly, Congress did not intend "to limit our jurisdiction over entry or exit of carriers, through acquisition of control or otherwise, in light of its direction to 'regulate[e] interstate and foreign commerce in communication by wire and radio so as to make available, so far as possible. . . a rapid, efficient, Nationwide, and worldwide wire and radio communications service with adequate facilities at reasonable charges.'" 72 FCC 2d at 102.

The Commission's exercise of Section 214 jurisdiction over any BOC divestiture would appear desirable if the Commission is to play its proper regulatory role in approving and supervising the attendant asset valuation and transfer. If the transfer of assets from the BOCs to AT&T's interstate operations is valued too high, the interstate ratepayer will be unfairly burdened. If such transfer is valued too low, the result could have anticompetitive effects for the interstate/interexchange market. The interstate components of a BOC divestiture are uniquely within this agency's primary jurisdiction, and Section 214 conditioning appears to be the most expeditious and effective way of ensuring that this considerable task would be properly executed.*

The Commission's *amicus* memorandum has advised the antitrust suit court that "Under Section 214. . ., the Commission has exclusive authority to authorize the construction and retirement of interstate and foreign communications facilities, and thus effectively controls entry into (and exit from) the market." 62 FCC 2d at 1111. Because "[t]he authority to control entry and exit is crucial to the Commission's mandate to create a communications network," the Commission has further advised the court that "any antitrust remedy which had the effect of subordinating our control. . . to the judicial enforcement of antitrust policy would . . . be contrary to congressional design." *Id*. at 1111-12. I trust, therefore, that the staff will closely examine the possible application of Section 214 to the BOC divestiture issues.

(3) Interconnection Policy

The new consent decree purports to establish requirements, terms, and conditions for BOC interconnection of facilities, services, and equipment with the local exchange and also provides that each BOC is to submit "procedures for ensuring compliance" with the Department of Justice and, by implication, in the event of dispute for review and determination by the court. These provisions in essence would supplant existing Commission rule and policy on interconnection with respect to BOC operations. The decree also contains a provision authorizing a BOC to petition the court for a waiver of the decree's technical standards for equal access with respect to pre-electronic switches upon a showing that such access "is not physically feasible except at costs that clearly outweigh potential benefits to users of telecommunications services."

---

* Sections 205 and 220 of the Act provide a possible alternative for asserting FCC jurisdiction over the asset and valuation transfer process.

The Commission's amicus memorandum advised the antitrust suit court of its jurisdictional interests in matters of carrier facilities interconnection:

> . . . any case involving interconnection might affect questions of regulatory policy, and we believe, therefore, that the doctrine of primary jurisdiction should apply.
>
> Where the Commission has directed carriers to interconnect their facilities pursuant to Section 201 [of the Communications Act],. . . the antitrust courts may not interfere with that policy judgment by directing otherwise. If the carrier were subject to different masters on such a basic communications policy matter, the Commission's ability to carry out its mandate might be diminished. 62 FCC 2d at 1113.

This Commission has occupied the field of carrier facility interconnection, and I see considerable danger to the effective and consistent implementation of our interconnection policies in allowing the Justice Department and the court to set different standards for interconnection of carrier facilities under the rubric of an antitrust consent decree. In my judgment, our affirmative action is required to ensure that the interconnection of carrier facilities remains under our primary jurisdiction.

As for equipment interconnection, while the Commission's amicus memorandum stated that it "has never considered its authority over equipment interconnection to displace the antitrust laws," it also advised the court of "the applicability of primary jurisdiction in cases where antitrust litigation may involve or affect regulatory policy." 62 FCC 2d 114.

The provisions of the consent decree purporting to govern BOC facility and equipment interconnection may be reasonable and appropriate. Moreover, it appears that there is no FCC statutory or regulatory bar against a carrier independently providing "better" interconnection than that presently required by our rules. In my judgment, however, this Commission should assert its primary jurisdiction over these matters and either adopt or reject such provisions according to our own independent policy judgment as to their desirability and efficacy. I believe it would be a serious mistake for this Commission to abdicate its interconnection authority and jurisdiction to the terms of the new consent decree or to "supervision" of the decree by the Justice Department or "interpretation" of the decree by the court.

(4) Tariff Regulation/Access Charges

The new consent decree contains provisions requiring the divested BOCs to provide "exchange access" pursuant to tariff and purports to prescribe the specific terms and conditions for such access to be embodied in the required tariffs. The decree also provides that the required tariffs "shall replace the division of revenues process used to allocate revenues to a BOC for exchange access provided for the interexchange telecommunications of BOCs or AT&T."

These consent decree provisions underscore the FCC jurisdictional concerns previously outlined with respect to interconnection policy, and, further, directly concern this Commission's exclusive jurisdiction with regard to tariff regulation and separations and settlements. As the Commission's amicus memorandum advised the court:

> Congress has entrusted the Commission with the sole authority to prescribe and approve rates, practices, procedures and regulations set forth in tariffs. Even a court with express statutory authority to review agency actions may not prescribe tariff provisions; it may only set aside the Commission's actions as unlawful, unreasonable or arbitrary, and then the Commission must reconsider its action. . . . The Commission must have this exclusive authority if it is to carry out its responsibilities under the [Communications] Act. . . . The Commission alone is empowered and equipped to make judgments of this kind, and its judgments should not be set aside in the context of sporadic antitrust actions.

62 FCC 2d 1115-16 (Citations and footnote omitted). Similar reasoning dictates that this Commission alone, in concert with Joint Board participation of State regulatory authorities, is empowered to prescribe separations and settlements procedures and actions.

While the relevant consent decree provisions may be interpreted as only requiring the divested BOCs to initiate and file conforming exchange access tariffs with the appropriate regulatory authority, the decree cannot thereby dictate the acceptance and approval of such tariffs by the regulatory agency. This Commission must retain its full and independent jurisdictional authority to approve, suspend, investigate, reject, modify or prescribe such tariffs pursuant to Sections 201-205 of the Communications Act. I can also find no authority to support whatsoever for any proposition that the terms of the antitrust consent decree with respect to "exchange access" charges may supercede the interstate/intrastate separations and settlements procedures which this Commission has prescribed in accordance with the Act. While it may be desirable as a matter of communications policy to prescribe a tariff scheme for access charges, and detailed element-by-element cost factors, such action is uniquely entrusted to this Commission's jurisdiction. I believe the FCC's primary jurisdictional interest in each of these matters must be firmly asserted and defended.

(5) Federal-State Jurisdiction

The operative provisions of the new consent decree are structured in primary part according to an "exchange"/"interexchange" distinction. While this distinction is apparently intended to track pending congressional legislation, it appears to bear little resemblance or relationship to the "interstate"/"intrastate" dichotomy that is the jurisdictional cornerstone of the existing Communications Act. Legislation may or may not be soon enacted, and the consent decree's departure from the the jurisdictional terminology of the existing statute and the Commission's mandates thereunder is very troublesome.

In particular, I am concerned that the consent decree, in essence and in effect, purports to "rewrite" the existing Act subject to the interpretation of the Justice Department and the court. I suggest that the staff examine the implications of this observation closely for any such effect would be wholly improper as a matter of law and could put this Commission's statutory mandate in perpetual conflict with the court's administration of the decree.

CONCLUSION

The Commission's amicus memorandum provides an excellent summary of the FCC's proper interests and expectations with respect to judicial review of the new AT&T-DoJ consent decree:

> The Court, we suggest, may not require entry [or, by necessary implication, exit from] the communications market, may not frustrate FCC orders to interconnect telephone systems, and may not base any antitrust relief upon tariff provisions that have been approved or prescribed by the Commission. These matters are implicitly delegated to the Commission's exclusive juris-

> diction. As to other specific issues that are within or directly affect the agency's regulatory policies, we believe the Court should refer any unsettled questions to the Commission under the doctrine of primary jurisdiction; where the Commission has settled such questions, the Court should take judicial notice of the Commission's decisions. We urge the court to take no action that will substantially alter the industry structure without initial consideration by the FCC of how such action will comport with the "public interest," as perceived by the Commission in light of its mandate under the Communications Act.

62 FCC 2d at 1119-20.

I repeat--it may well be that the antitrust "settlement" reached by AT&T and DoJ will serve the public interest in telecommunications as well as antitrust policy interests. My comments here should not suggest that I would have the Commission address itself to the new consent decree in other than a spirit of intergovernmental collegiality and respect for the province and authority of the court. I believe we should strive to recognize and accommodate the intentions of the parties under the antitrust law regime consistent with our independent regulatory responsibilities and prerogatives. However, in instances of apparent conflict we should be mindful that our first duty is to preserve the FCC's existing congressional mandate for the formulation and execution of communications policy in the public interest.

In light of the court's stated intent to apply Tunney Act procedures to the new decree, it appears that the Commission will have the opportunity to advise the antitrust decree court of our jurisdictional concerns and policy interests regarding the AT&T-DoJ accord. I am hopeful that the 60-day comment period will provide sufficient time for us to prepare our views and positions with adequate detail and clarity. However, if questions of uncertain resolution arise in our deliberations, we should consider the possibility of requesting that the district court refer such issues to us under the established doctrine of primary jurisdictions. In this regard, it is my understanding that where the regulatory agency has primary jurisdiction with respect to factual and legal questions involved in antitrust proceedings, such referral is customary if not also mandatory. See AT&T v. MCI Communications Corp., 496 F.2d 214 (3d Cir. 1974).

Joseph R. Fogarty

Joseph R. Fogarty
Commissioner

Mr. FOGARTY. I have two concerns which I will summarize. As you suggested, the more lengthy statement, which I have submitted to the committee, can be made a part of the record also.

Senator SPECTER. Without objection, it will be made a part of the record.

Mr. FOGARTY. With regard to the upward rate pressure problems, Mr. Chairman, I see some difficulties. And I do agree with the Chairman that the Commission's procompetitive policies over the years, which are just now about to be implemented, are a cause of upward rate pressures at the local level. But it appears to me also that this consent decree will create problems of its own which will make it more complex for the State regulators to keep local rates down. One of the problems is the fact that about two-thirds of AT&T's assets will be transferred when the consent decree is implemented. As a result, there must be some valuation of these assets. Who is to evaluate the assets and how they are to be valued is of paramount import with respect to how local rates will ultimately be affected.

That is one of the more serious problems that I have with the proposed consent decree. That is that it does not spell out with sufficient definiteness how that valuation will be accomplished.

As I point out in my statement, Mr. Chairman, if the assets are valued too low as they are transferred from the local BOC's to AT&T or if they are valued too high, there will be either an adverse impact on local rates—local rates may be forced up dramatically—or an adverse and inequitable impact on interstate rates.

I think either the Justice Department must, as it proceeds before Judge Greene, specify more definitely how that valuation is to occur, or the Commission in its comments to Judge Greene must make clear to the judge why it is important that this valuation process be established clearly before the consent decree is carried out.

The second area of concern, Mr. Chairman—and I spell it out more completely in my prepared statement—is that the consent decree as modified, as I view it, will leave the BOC's, the new BOC's, once divested, practically naked. I think that this is far more serious a flaw in the consent decree than perhaps even the valuation issue. As I see it, the local BOC's, once divested, will be able to provide only basically dial tone, and they will be excluded from providing the marvelous new enhanced services that even the FCC has allowed them to provide under its *Computer II* decision. I think this is probably the most serious flaw which you must address, Mr. Chairman. If the BOC's, the new BOC's once divested, are not allowed to participate with the new technology and to deliver it to the local ratepayer, that in and of itself, I think, will cause local rates to increase.

Mr. Chairman, I suggest that these two areas that I have outlined and which have been stressed also by the Chairman should be considered by this committee. Thank you.

Senator SPECTER. Thank you very much, Commissioner Fogarty.

Mr. Fowler, picking up on your testimony at the start, you say that it is an oversimplification to attribute significant rate increases to the divestiture alone, that there are an amalgam of factors which come into play here. But the tone of your testimony is that you do expect rates to increase. What is your best judgment as to how much telephone rates are going to increase in the immediate future as a result of all the factors you particularize?

Chairman FOWLER. I am not sure we are prepared to give a specific, but let me pass this question off to our expert, Mr. Halperin, on the significance of the local rates, Mr. Chairman.

Mr. HALPERIN. Senator, if I could, the question of how much local rates will increase over the next 2 or 3 years largely depends on several decisions that will be made over the next year. I would say that the increase, the range of figures that we have seen, which run from anywhere from about 15 to 20 percent a year up to, perhaps, 100 percent over 5 years, would be possible, depending upon the decisions and in particular the one the Chairman highlighted, the decision that will be made by the Commission in the Federal-State Joint Board on Separations. That will basically answer the question.

Senator SPECTER. The estimates are that they may double even sooner than 5 years. Do you think that that is a possibility, Mr. Halperin?

Mr. HALPERIN. There are some areas where it may take place that way, Senator.

Senator SPECTER. Some areas where it may go up as much as doubling in less than 5 years?

Mr. HALPERIN. Yes, sir, areas that currently have and may have had for 5 to 10 years already a rate of $3, $4, or $5 for basic service may double. That, however, is a $5 increase. A similar $5 increase for those of us who live in Virginia would only be a 25-percent increase. So, the dollar figure, because of the wide disparity in local rates now, a similar dollar figure would be a radically different percentage for different localities.

Senator SPECTER. That is true, but it may be affecting people who have a very small ability to pay. A doubling is a doubling on anybody's budget. Where do you think that it may go up by as much as doubling?

Mr. HALPERIN. Senator, as I indicated, the area where we would see it double would be the areas where the current rates are extremely low now, have been held at very, very low levels for long periods of time——

Senator SPECTER. Where is that? That is my question.

Mr. HALPERIN. It would basically be in smaller exchanges, the rural areas that are served by small independents rather than by the Bell system.

Senator SPECTER. And that might impact upon people who could least afford any change at all, of course.

Mr. HALPERIN. Yes, sir, that is one factor that I know is being considered by the Commission.

Mr. FOGARTY. Mr. Chairman, if I may add to Mr. Halperin's comments, I think his analysis is very conservative. I think in the rural areas we can expect within less than 5 years a doubling if not a tripling of local residential rates.

Senator SPECTER. Mr. Halperin has suggested, Mr. Fogarty, that it may go up double next year in some areas. Have you not?

Mr. HALPERIN. Senator, not next year. I would say that the doubling prospect would probably be over about 2 years after the separations changes begin to take effect. I would not anticipate a doubling anywhere next year.

Senator SPECTER. I see, a doubling within 2 years after separation; but that is substantially in advance of a 5-year period.

Mr. EPSTEIN. Senator, one important point, I think, to keep in mind, which Mr. Halperin and, I think, Commissioner Fogarty both mentioned is the fact that, as far as the separations process goes, that is a change which was within the control of the Commission. The factors that you are talking about, the prospect of a doubling of local rates for people in rural areas, has to be an extremely important part of whatever decision the Commission makes.

Senator SPECTER. One of the concerns that I have is that, with a number of things happening at the same time, it may present what some might believe to be an opportunity for massive increases, with everybody pointing the finger at everybody else. That is something which really ought to be avoided so that we can particularize and specify what the causes are. If it is attributable to the divestiture, so be it; let us identify that and try to deal with it. If there are other factors which come into play just coincidentally, then perhaps something ought to be done to separate them in time from their effect so that we do not have a situation where there are a number of factors coming into play at the same time and then the consumer cannot identify what it is which is causing the increase; but he simply knows that the increase is coming. Then everybody is in a position to point the finger at everybody else.

Let me see if I can understand some of the specific impacts here.

Mr. Halperin, you talk about the separations decisions which the Commission and the Joint Board are considering. Can you amplify just what that means?

Mr. HALPERIN. Yes, sir, one of the biggest questions in telecommunications is the way that the costs of the local plant are divided. A large percentage of the costs that are associated with telephone service are costs that are incurred for both local and for long-distance service. The wiring in your house, the line that runs to your house is the same line; and you use it for both local and long-distance service.

Senator SPECTER. Are you suggesting that there is going to be a major change in the way the Commission views that separation of costs now?

Mr. HALPERIN. Both the Federal-State Joint Board, which is considering it, and the FCC have endorsed in principle a number of changes which have been recommended by virtually every party who is concerned here, including the parties who represent the small independent companies that would be impacted. Those changes will both see a general reduction of the costs that are assigned to the interstate jurisdiction but at the same time a principle which would have a special factor to take account of and to buffer increases on precisely the small rural areas where people may not be able to pay them, both of those factors have been adopted in principle by the Joint Board.

So, I expect to see significant changes. But I also expect and the entire seven members of the Joint Board, State and Federal, have already endorsed the notion of applying special principles, special measures to deal with precisely the problem you are raising.

Senator SPECTER. What will the effect be on long-distance rates as a result of the changes made by the Federal-State Joint Board?

Mr. HALPERIN. Senator, we would expect that what will happen in this year of inflation is they will either hold steady or go up less than they would otherwise.

Senator SPECTER. That will shift more of the cost to the local rates?

Mr. HALPERIN. Yes, sir.

Senator SPECTER. But there will be some special protections for rural areas as those plans are now being projected?

Chairman FOWLER. We are looking, Senator, at a mechanism under a generic formula that we could apply to target the high-cost exchanges, typically rural exchanges with a subsidy.

Senator SPECTER. A mechanism under a generic formula?

Chairman FOWLER. Yes, sir.

Senator SPECTER. Which would do what?

Chairman FOWLER. Which would target a subsidy to those high-cost, rural exchanges that would need it in order to keep the local cost down more than they would otherwise.

Senator SPECTER. Who is going to pay the subsidy?

Chairman FOWLER. That would be taken out of access charges paid to other normal-cost exchanges and spread and targeted to those that needed it.

Senator SPECTER. What does that mean in English?

Chairman FOWLER. Essentially, it means that long-distance ratepayers would be subsidizing certain high-cost rural exchanges but not all, only those that would need that.

Senator SPECTER. How is the determination made as to which rural areas are going to be subsidized?

Chairman FOWLER. I will turn to Mr. Halperin on the technical aspects of that.

Mr. HALPERIN. Senator, there will not be a choice of some rural areas versus other rural areas. Essentially, what will be examined are those areas where the cost of providing the service is exceptionally high. There is currently a massive project which is being undertaken both by ourselves at the Commission in cooperation with the Federal-State Joint Board and on an independent although parallel track by the industry, the first comprehensive attempt to determine the cost characteristics of local service across the Nation, not just the Bell System but the small independent companies, some 1,500 of them, which may have radically different costs.

To respond to your question, it will not be good versus bad rural exchanges that will get the benefit. It will be everywhere that needs it. That would be based upon the costs of serving the people.

Senator SPECTER. Has any consideration been given to or would it make any sense to defer that kind of a change to a point in time after there has been some experience with the divestiture?

Mr. HALPERIN. Senator, I think that to phase this change in, I think you are absolutely right. And the other aspect, the generic formula that Chairman Fowler mentioned, is also a unanimous decision by all seven members of the Federal-State Joint Board that a transition mechanism will be needed to insure that there is no dramatic, precipitous rise as a result of separations changes in any area's rates.

Senator SPECTER. Well, beyond what you have just testified to, has any consideration been given to deferring any change to a point in time after the divestiture is completed and the effects of the divestiture are known?

Mr. HALPERIN. Senator, this is a matter which is before the Joint Board. At the same time that some parties in this docket have argued for delaying any changes in order to wait for the consent decree, others have been arguing for speeding up the changes so that the new environment that would take place under the consent decree can develop in a fair manner without one particular long-distance carrier bearing certain cost responsibilities for local exchanges that other carriers do not bear. But that is a factor I am sure will be considered by the Joint Board and ultimately by the Commission.

Senator SPECTER. Mr. Fowler, you have particularized a number of factors which are going to cause increases in cost. You talk about new depreciation policies, some underaccrual in the past. Just what is the essence of the new depreciation policies that you referred to?

Chairman FOWLER. The essence is it permits a faster writeoff of equipment by the telephone companies, taking into account the rapid technological changes that are occurring in the industry.

Senator SPECTER. How much faster?

Mr. HALPERIN. Senator, the essential change that has taken place has been from what was called the whole-life method to what is called the remaining-life method. There is no simple answer to your question since——

Senator SPECTER. There has not been one to any question.

Mr. HALPERIN. It is, as Chairman Fowler mentioned, one of the most complicated fields around.

Senator SPECTER. Whole life to what?

Mr. HALPERIN. To remaining life.

In the first case, it was not only possible but it routinely occurred that the capital investment costs were not recovered over the life of the plant. Now a remaining life——

Senator SPECTER. Capital costs were not recovered over the life of the plant?

Mr. HALPERIN. Yes.

Senator SPECTER. Do you mean there were capital costs which were never allocated for an expense at all?

Mr. HALPERIN. They would be recovered exactly as Chairman Fowler said, by future ratepayers. Essentially, what was done was to create a lump of costs that will have to be paid back; the law requires it will be paid back. What was done for a long period of time was to sort of push them ahead in the future and assume that someone else would pay for them. But, as the pool of unrecovered costs——

Senator SPECTER. But that is what always happens on a depreciation schedule. Some is deducted now, and some is deducted in the future. The future ratepayer necessarily pays for some of those costs.

Mr. HALPERIN. Yes, Senator, but one of the principles that we believe is sound is that the capital should be recovered over the entire life of the plant, not in the first year but over the entire life.

If a piece of plant exists for 10 years, you are absolutely correct, you do not recover all those costs in the first year and place a massive burden; but you spread it over the 10 years. The situation that we were finding ourselves in is that we would recover over that 10-year period, say, 30 percent of the costs. After that piece of plant was retired from service and had been relegated, perhaps, to a junk pile somewhere, there would still be 70 percent of the costs around which would have to be recovered by ratepayers who received no benefits from the plant.

Mr. EPSTEIN. Senator, if I may amplify a little bit on that, I would make two points. One is that it was generally recognized by the industry and everybody who commented in our proceeding that there had been underdepreciation, less than straight line; and there was a potential problem with plant getting obsolete.

The second point I want to make is that our——

Senator SPECTER. Can you give us a ballpark figure as to what the time was on depreciation in the past and what it is now so we have some idea as to the change in the depreciation schedule?

Mr. EPSTEIN. It depended upon the different classes of plant that were involved.

Senator SPECTER. Give me an example, one class. How long it used to take, and how long is it going to take now?

Mr. EPSTEIN. I do not have the figures at my fingertips.

If I may make one additional comment, our Commissioners asked the staff this very question: How can you particularize this? What do we mean in dollar terms? We prepared for our Commission what we call the report card, which took each of these different changes that we are talking about: depreciation, expensing of inside wiring, this question about separations. We prepared for our Commission a dollar-by-dollar effect on local rates. We would be happy to submit that for the record. That is particularized as to our best guess over the next 3 years as to what effect each of these particular changes will have on local rates.

Senator SPECTER. We would be pleased to receive that. It would be helpful if you could simplify it with a summary statement at the outset as to the tenure of depreciation in the past contrasted with the tenure of depreciation as you currently plan it. Without objection, that will be inserted into the record.

[Material referred to follows:]

FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D. C. 20554

OFFICE OF
THE CHAIRMAN

APR 0 5 1982

Honorable Arlen Specter
United States Senate
Washington, D. C. 20510

Dear Senator Specter:

Pursuant to our discussion on March 25, 1982 concerning the effects of recent Commission decisions on telephone rates, I enclose a brief summary of the near-term effect of several of the most important of these decisions as well as a more detailed Public Notice released by the Commission.

Although these decisions have the short-run effect of raising average telephone bills, in most cases they lead to a faster writedown of obsolete equipment. They make reduction in future rates possible because these future rates will be on a smaller base of underdepreciated "assets." Furthermore, these decisions allow for more efficient service and more competition.

In closing, allow me to once again offer, on behalf of myself, my fellow Commissioners and our staff, to provide you and your staff any additional information on this or related issues. Our staff and I am also available to assist you in any way we can.

Sincerely,

Mark S. Fowler
Chairman

Enclosures

Summary of the Effects of Recent Decisions

On January 21, 1982 the Commission released a Public Notice that estimated the effects of several important Commission decisions on telephone revenue requirements and hence on rates. The figures were supplied by the telephone companies' forecasts and may be inexact.

Three major changes are detailed in the attached Public Notice: changes in depreciation methodology which, in many cases, allow faster depreciation expecially of previously underdepreciated assets; the expensing of station connections (inside wiring); the amortization of previously capitalized station connections; and the "$200 Rulemaking" which allows expensing of items of $200 value or less, contrasted with the earlier $50 limit.

These changes are expected to raise revenue requirements over the next several years. The table below summarizes the expected increases in revenue requirements on an overall firm, and on a per main (line subscriber) per year basis. It should be noted, however, that how these revenue requirements are allocated among subscribers will vary depending on subscribers' use of the network. Thus, the interstate portion will be allocated largely to those who make heavy use of the interstate network and much of the intrastate portion will be allocated to those who make heavy use of the intrastate network.

Table

	1981		1982		1983	
	Inter	Intra	Inter	Intra	Inter	Intra
AT&T	$4.87	$12.37	$10.37	$31.04	$13.69	$40.99
GTE	4.17	12.43	7.95	23.25	10.72	32.08

Total Company */
(Millions)

	1981		1982		1983	
	Inter	Intra	Inter	Intra	Inter	Intra
AT&T	$410	$1,041	$899	$2,689	$1,222	$3,656
GTE	10	119	84	246	109	326

As is more fully detailed in the attached Public Notice, the largest portion of these increases results from the changes in depreciation methodology allowed.

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*/ Does not contain impact of $200 expense rulemaking because data was not supplied by GTE.

PUBLIC NOTICE

FEDERAL COMMUNICATIONS COMMISSION
1919 M STREET N.W.
WASHINGTON, D.C. 20554

News media information 202/254-7674. Recorded listing of releases and texts 202/632-0002.

REPORT CARD as it was released to public on january 21,1982

Pursuant to Commission direction, the Common Carrier Bureau has developed and sent to the Commission a "scorecard" containing the Bureau's best estimates of the revenue requirement impact of Commission actions. The revenue requirement impacts, stated on a per subscriber basis, need not and, based on current state policies, will not be the same as per subscriber rate impacts, which will depend on state and federal rate decisions. The impact estimates for actions taken by the Commission are being released herein.

The information contained herein was originally prepared to assist the Commission and not for public dissemination. It should be borne in mind that the estimates contained herein--while perhaps the best available--are based upon carrier forecasts which are untested and which may ultimately prove to be unreasonable.

Using the information available to it, the Bureau's Accounting and Audits Division has attempted to estimate, as precisely as possible, the impact upon subscribers as a result of a number of recent or anticipated Commission decisions. The calculations of revenue impact are limited to 1981, 1982 and 1983. However, the impact of decisions such as Dockets 20188 (ELG and remaining-life) and 79-105 (Expensing of station connections) will run well past 1983. The changes estimated for 1981, 1982 and 1983 reflect changes from a 1981 base prior to any changes.

Except for the $200 Rulemaking item for which data was provided in Docket No. 81-273, all of the calculations on a "per subscriber" basis use mainline and equivalent 1/ data furnished by AT&T and GTE for 1980 and part of 1981.

1/ Main telephones or mainlines are defined by Bell in accounting letters as those telephones which are connected by an individual or party line circuit directly to a central office switchboard or a toll board. Only one telephone from each central office line is classified as a main telephone. Equivalent main telephones are defined as voice grade circuits which terminate in other than a main telephone; that is, lines that terminate in PBX or centrex switching equipment which is connected to a central office.

The staff calculated for year-end 1981, 1982 and 1983 the number of mainline and equivalent stations by applying a 3% per year growth factor to prior year's balance. The use of mainlines and equivalents may be somewhat misleading because it ignores the fact that the interstate portion is absorbed through interstate usage tariffs and not on a per subscriber basis. Similarly, any increase in state revenue requirements will be recovered based upon the different rates stated in individual local tariffs. Thus, the increase at both the federal and the state level will not be recovered equally from all main stations or subscribers but will vary depending upon usage or other considerations. However, the use of computations based upon mainlines and equivalents does provide a readily understandable point of reference from which to measure the impact of any change.

Also, the calculations are presented on an annualized interstate and intrastate basis. In all cases except for 1981 depreciation calculations pertaining to normal represcription and remaining-life rates, a 25% interstate, 75% intrastate division (which approximates the SPF factor for non-traffic sensitive plant) is used. In the case of the 1981 depreciation calculations, a 33% - 67% split is used because rates for Long Lines are being prescribed in 1981 and the impact of that prescription will fall entirely on the interstate jurisdiction.

This Notice covers the following areas:

A. Depreciation

  1. Changes in service life estimates (normal represcription)
  2. Remaining life depreciation rates
  3. Terminal equipment blanket depreciation filing
  4. Equal life group depreciation (or alternatives)

B. Station Connections - Docket 79-105 2/

C. $200 Rulemaking

Depreciation

The estimated annual increase in per subscriber revenue requirements for depreciation is as follows:

	1981			
	AT&T		GTE	
	Inter	Intra	Inter	Intra
1. Changes in service life estimates (normal represcription)	$ .75	$1.51	$ .52	$1.57
2. Remaining life depreciation	1.53	3.10	1.04	3.13
3. Terminal equipment blanket	1.88	5.61	.52	1.57
4. Equal life group depreciation	-	-	-	-
Total	$4.16	$10.22	$2.08	$6.27

2/ The Commission's First Report and Order was released on March 31, 1981 (46 FR 19481).

	1982			
	AT&T		GTE	
	Inter	Intra	Inter	Intra
1. Changes in service life estimates (normal represcription)	$1.07	$ 3.20	$ .81	$ 2.23
2. Remaining life depreciation	1.90	5.71	1.32	3.75
3. Terminal equipment blanket	1.82	5.45	.51	1.52
4. Equal life group depreciation	1.08	3.24	1.01	2.84
Total	$5.87	$17.60	$3.65	$10.34

	1983			
	AT&T		GTE	
	Inter	Intra	Inter	Intra
1. Changes in service life estimates (normal represcription)	$1.60	$ 4.78	$ .98	$ 2.95
2. Remaining life depreciation	2.72	8.14	1.48	4.43
3. Terminal equipment blanket	1.77	5.29	.49	1.48
4. Equal life group depreciation	1.78	5.33	1.87	5.51
Total	$7.87	$23.54	$4.82	$14.37

The depreciation calculations for items 1 through 3 are based upon data submitted by the carriers in October 1981 and Depreciation Rates Branch estimates for those carriers expected to file new depreciation schedules in November 1981 and in 1982 and 1983. The normal represcription for the 1981 companies (item 1) for all accounts (excluding station connections) will be considered by the Commission shortly, and covers some 10 AT&T Companies and 4 GTE Companies. The 1982 and 1983 calculations for item 1 represent the estimated impact which is a result of represcriptions of service lives for those companies coming up for represcription in those years, i.e., the "1981" and "1982" companies. Also, for the 1981 companies, the effect of the proposed change in 1981 from whole-life rates to remaining-life rates (item 2) as allowed in Docket 20188 is shown. AT&T's remaining-life rates are based upon "actual" reserve allocation required by the Commission in Docket 20188, Supplemental Opinion and Order (46 FR-50952-10/16/81). The 1982 and 1983 calculations for item 2 reflect Depreciation Branch estimates for those companies up for represcription in those years.

Under the Commission's decision in Docket 20188, ELG for Outside Plant was to be allowable in 1981. However, as can be seen, our calculations (item 4) show no revenue effect in 1981. The calculations project approval in 1982 for all companies' Outside Plant and Central Office Equipment. 1983 calculations consider all other plant for which ELG or CRS would be applicable. The revenue requirement effects are based upon data submitted by the carriers in March 1980.

Finally, this Notice contains the effect (item 3) of changes in the depreciation accruals for a blanket filing for those carriers seeking a change in depreciation rates for terminal equipment from whole-life to remaining-life rates (Docket 20828). The calculations for 1981 utilized data submitted in October 1981 to the Depreciation Rates Branch and estimates by the Branch. The impacts shown for 1982 and 1983 represented Depreciation Rates Branch estimates.

Station Connections

Docket 79-105 ordered several changes in the accounting treatment of station connections. First, effective October 1, 1981, it ordered the expensing of station connections - inside wiring. Second, it provided for the amortization of the embedded investment in inside wiring starting October 1, 1981. Finally, it established a new subclass in the station connection account, Station connections - other, for that portion of the station connection account which will continue to be capitalized. The carriers were ordered to phase-in their change from capitalizing to expensing over 4 years. This was to be accomplished by expensing 25% of all new station connection - inside wiring in year one, 50% in year two, 75% in year three and 100% in year four. Therefore, after three years, all station connections - inside wiring would be expensed. However, the Commission allowed those companies who wished to flash-cut rather than phase-in to do so if state commission approval was obtained. These calculations reflect the effect of some 9 AT&T jurisditions who have sought and been granted flash-cut approval by their respective state commissions. Using 1981 as the base year, the AT&T change to flash-cut has added some $40.0 million in revenue requirements for 1981 and $234.6 million in 1982. There is an offsetting reduction of $1.4 million in 1983. This information was supplied by AT&T. Although GTE reported that it have been given flash-cut approval in 12 jurisdictions as of October 1981, it did not provide any information as to the revenue requirement of any election to flash-cut. These computations therefore omit any adjustment for possible flash-cut changes for GTE. These calculations reflect these increases being borne by all customers on a per subscriber basis and not by the cost causative customer. If the states do pass the costs on to the causative customers, there would be no positive revenue requirement effect on the general body of rate payers and they will no longer be required to bear added future costs.

Finally, with regard to Station connections - other, the calculations include the depreciation effect for such investment. The change in annual per subscriber revenue requirements for the amortization of the embedded investment in inside wiring and the continued depreciation of the investment in station connections - other shows a reduction in revenue requirements. This reduction is created by the increased length of time over which the investment is recovered from the ratepayer. Prior accounting for station connections used an average life of seven years. In Docket 79-105 the

Commission ordered the embedded investment in inside wire to be amortized over ten years.

For the total station connections area an estimated 25% interstate, 75% intrastate split is utilized in developing that breakout. This split is based upon AT&T's 1980 SPF factor.

The estimated net revenue effect, increase, of the changes in station connections for AT&T over 1981 base is estimated at $241 million for 1981, $1,448 million for 1982 and $1,987 million for 1983. For GTE the total effect is $79 million in 1981, $160 million in 1982 and $240 million in 1983.

The calculations per subscriber on an annual basis are as follows:

	AT&T		GTE	
1981	Inter	Intra	Inter	Intra
Station connections - inside wiring - expensed	$ 3.16	$ 9.47	$ 2.61	$ 7.83
Imbedded investment - amortized	(1.65)	(4.94)	(.31)	(.94)
Station connections - other depreciated	(.80)	(2.38)	(.21)	(.73)
Total	$ .71	$ 2.15	$ 2.09	$ 6.16

	AT&T		GTE	
1982	Inter	Intra	Inter	Intra
Station connections - inside wiring - expensed	$ 6.37	$19.08	$ 4.86	$14.49
Imbedded investment - amortized	(1.53)	(4.60)	(.30)	(.91)
Station connections - other depreciated	(.65)	(1.96)	(.51)	(1.42)
Total	$ 4.19	$12.52	$ 4.05	$12.16

	AT&T		GTE	
1983	Inter	Intra	Inter	Intra
Station connections - inside wiring - expensed	$ 7.47	$22.42	$ 7.38	$22.23
Imbedded investment - amortized	(1.24)	(3.73)	(.79)	(2.36)
Station connections - other depreciated	(.66)	(2.00)	(.69)	(2.16)
Total	$ 5.57	$16.69	$ 5.90	$17.71

$200 Rulemaking

On October 7, 1981, the Commission adopted an accounting change (Docket No. 81-273) which raised the dollar limit for the expensing of minor items from $50 to $200 and allowed the amortization of the embedded balances over a 5 year period. Prior to this change, all such expenditures over $50 had to be capitalized. This accounting change will become effective April 27, 1982. Any carrier may, at its option, adopt these changes effective no earlier than January 1, 1982. Therefore, there is no revenue effect for 1981. However, based upon data submitted by AT&T and GTE during the proceeding, an increase in revenue requirements in 1982 of $105 million and $32 million, respectively, is anticipated. Based upon a 25% - 75% interstate/intrastate revenue split, this represents for AT&T a per subscriber line increase of $0.31 relative to interstate and $0.92 relative to intrastate. GTE's per subscriber line increase for 1982 is $0.25 interstate and $0.75 intrastate. GTE has no 1983 estimates. AT&T's 1983 increase is estimated at $86 million and its per subscriber line revenue increase is $0.25 interstate and $0.76 intrastate.

Conclusions

While the actual rate impact of those changes on individual users depends on state and federal rate decisions, the total impact of the above decisions and proposals represent an estimated annual revenue requirement change per subscriber over the base year as follows:

	1981		1982		1983	
	Inter	Intra	Inter	Intra	Inter	Intra
AT&T	$4.87	$12.37	$10.37	$31.04	$13.69	$40.99
GTE	4.17	12.43	7.95	23.25	10.72	32.08

Total Company 3/
(Millions)

	1981		1982		1983	
	Inter	Intra	Inter	Intra	Inter	Intra
AT&T	$410	$1,041	$ 899	$2,689	$1,222	$3,656
GTE	10	119	84	246	109 4/	326 4/

3/ - Does not contain impact of $200 expense rulemaking because data was not supplied by GTE.

Senator SPECTER. Chairman Fowler, you did make a reference to a mandate on expensing stationary connections. By expensing, I take it you mean a writeoff in 1 year? That is the customery definition for expensing, right?

Mr. HALPERIN. Yes, sir.

Senator SPECTER. How long had the depreciation schedule been in the past on stationary connections?

Mr. HALPERIN. I believe it was approximately 10 years. There were portions. The station connection account is in two different parts. I believe one part was roughly 10 years, and another part was roughly 20 years. However——

Senator SPECTER. Is not that a very drastic change, to move from 10 years or 20 years to a single-year expensing?

Mr. HALPERIN. Sir, as Mr. Epstein just mentioned, both the impact of this—this has been phased in and being phased in over a 4-year period. With respect to the embedded costs, it is being phased in. Those costs are being amortized over a 10-year period.

Senator SPECTER. What is an embedded cost?

Mr. HALPERIN. Those are the costs which have been incurred in the past which have been capitalized and are part of the rate base.

If I could, Senator, I would just like to point out that the overwhelming majority of the station connection costs, well in excess of 90 percent of them, are not physical plant but is labor. What was being capitalized was not a piece of hardware or a building but was the actual labor, the cost of the labor, the wages that were paid.

Senator SPECTER. But it was in connection with some capital asset?

Mr. HALPERIN. It was in connection with the actual installation of the inside wire, the value of the wire itself.

Senator SPECTER. Are you suggesting that would not be a fair allocation to the capital asset?

Mr. HALPERIN. I am trying just to mention that, in expensing it, it is not at all illogical to cover the wages, the actual cost of having someone go out there and install the inside wire as an expense rather than as a capitalized cost.

Senator SPECTER. Mr. Fowler, you also refer to the deregulation, CPE removal, and changes in the separation process. Could you amplify on what you meant by that?

Chairman FOWLER. With respect to terminal equipment, telephones, and other equipment that attaches to the end of the wire, we have a competitive market out there. So, this Commission made a decision to deregulate the sale of CPE, which means that under our decision in *Computer II* the telephone companies would no longer be able to sell telephone equipment, that is CPE, under tariff through the phone company. It also meant that, if the Bell System did sell it, it had to do so through a fully separated subsidiary in order to assure us that there would not be the use of a monopoly position to subsidize their activities in an unregulated CPE environment.

We thought that it made sense to stimulate full, fair, and publicly beneficial competition by this device of having a totally unregulated CPE market with the telephone companies able to participate but only under certain structural safeguards.

The way that works out is, since the CPE was part of the rate base and since it is being removed from the rate base, it means that there will be pressure on local rates as a result of eliminating CPE from the rate base. There is a contribution through separations, a subsidy visited on local exchanges and paid for by the long distance user. That is fairly complex, but when you take the equipment out of the rate base, then that subsidy that flows from the interstate ratepayer is removed. I do not know if I am making that clear or not. That will cause some upward pressure on local rates since that subsidy will no longer be there.

Changes in separations means that, looking at what we call non-traffic-sensitive plant in the local exchange, we may change the method to allocate the cost of plant between long distance service and local service. In other words, the line from your home to the local telephone company can be used either to make a long distance call or to make a local call. There is a cost involved in that equipment. So, how do we allocate that to determine how much of the costs should be paid for by the interstate service as opposed to the local exchange?

Through the Federal-State Joint Board, we are moving that line between long distance and local cost and taking less of a subsidy from the interstate service and putting more of the costs on the local exchange. That will cause some increase in the local rates. Part of that is made necessary by the competition in the interstate long distance market now. That subsidy cannot be paid by AT&T if it is going to compete with the other people who are competing in the long distance market.

Senator METZENBAUM. Mr. Fowler, let me ask some questions. I heard over a period of time about the decision permitting competition so that other companies could sell their product. Then I hear more and more about the fact that, when you use that product, AT&T sees fit to charge you so much for each additional unit that you have in your home. I am not a sophisticate in the area of telephone usage or telephone cost, but it would seem to me that it does not cost any more to have 10 phones or 4 phones on the line in your home than it does to have one. You pay for the equipment to be plugged in at the installation, and then you go out and buy 4 phones. For each one you are supposed to pay $1, $2, or $3 a month.

My question is this: If you charge $1, $2, or $3 a month using 4 phones, I guess you can charge $15 or $20 or $30 a month. It is just a question of, once the formula is set, it is like the old story with the prostitute.

Chairman FOWLER. I am not familiar with that one.

Senator METZENBAUM. The point is, how is that justified? I have never quite understood that. Maybe that does not fall within your realm, but maybe you can explain it to me.

Chairman FOWLER. I am going to ask Mr. Halperin to respond to you, Senator, on that.

Mr. HALPERIN. Senator, you are right; it does not fall within our realm. That is a question which is decided under State rates.

With respect to interstate rates, if you pick up four phones and you have four people in your house making a long distance call, you are charged exactly the same as if one person does. The theory behind that, as we understand it, is what is called value-of-service pricing. This is a matter which different States have reacted differently to. The situation in your State might be quite different than in another State in terms of those charges. But that is a matter that each State is free to decide on by itself. They have, in fact, made different decisions.

Senator **METZENBAUM**. As an expert in the field, is there any justification for it? Does it cost the company any more to have four lines in your home than one?

Mr. **HALPERIN**. Senator, the FCC has not adopted, indeed has explicitly rejected, the notion of value-of-service pricing.

Senator **METZENBAUM**. I did not ask you that.

Mr. **HALPERIN**. So, my answer would be, from my perspective, no.

Senator **METZENBAUM**. Thank you. That was the answer. Thank you, Mr. Chairman.

Senator **SPECTER**. Mr. Chairman, would you care to question?

The **CHAIRMAN**. Thank you very much. I want to say that in all of these matters we certainly want to be fair to the companies. I see some people who want to persecute companies simply because they are corporations and are in business to make profits. But they cannot pay their stockholders if they do not make a profit.

On the other hand, I think our first duty is to the public. We have got to take every reasonable, honorable step we can to keep rates down: Telephone rates, power rates, and other rates. The longer I stay in the Senate, it seems I see more greed on the part of some people who want to take advantage. I am not specifying any particular company or any particular individual.

Our duty is to the public. Is that the way you see it?

Chairman **FOWLER**. Yes, sir.

The **CHAIRMAN**. Thank you.

Senator **SPECTER**. I have one final question which I will direct to you, Chairman Fowler, before we move to the next panel.

As you project all of these items of depreciation, which has occupied a substantial amount of your testimony, in terms of changes which have been made, what is the range of the impact that that would cost the ratepayer? Will these depreciation changes have the potential for increasing rates 10 percent, 20 percent, or what?

Mr. **HALPERIN**. Senator, that will be included in the scorecard we give you. The number that we had was somewhat under $1 a month for those depreciation changes per station.

Senator **SPECTER**. That could be 20 percent for a $5 payer.

Mr. **HALPERIN**. Yes, sir.

Senator **SPECTER**. It could be 10 percent for a $10 payer.

Mr. **HALPERIN**. Yes, sir.

Senator **SPECTER**. The thought crosses my mind, as I hear about all of these changes, that there is an extraordinary complexity at the particular time that the divestiture occurs when we are trying to isolate and find out what is happening. It is just a preliminary observation on my part, but there are some extremely complicated matters which are coalescing at the same time. You talk about significant changes in the Federal-State Joint Board. You talk about very substantial changes on the terminal equipment deregulation and new depreciation policies.

The thought on my mind is whether it might not be more in the public interest to have some of these changes deferred until we can assess what the impact is on the divestiture on AT&T.

Chairman FOWLER. Senator, I have one basic response. There has been some sentiment by a lot of thoughtful people to the concept you just expressed. Our view, however, is that the consent decree involves basically a change in ownership of certain facilities. It does not involve either ratemaking or allocation of costs as between intrastate and interstate ratepayers, the cost which each will bear. Therefore, in our view, the consent decree does not have any material capability to significantly impact on local rates, which is a concern of the Congress and of many thoughtful observers.

We believe—and we would have in any case, had we not had this consent decree—that we must proceed along the lines I have indicated here to have more realistic depreciation rates, to deregulate terminal equipment in order to provide better products to the consumer at lower cost, to make a more realistic assessment of where the costs should be borne as between intrastate and interstate ratepayers. We would have done those things in any case because we believe it is in the greater public interest to do those things.

Senator SPECTER. Mr. Fowler, how can you say that it does not have any impact, the divestiture has no impact on local rates, when it may well be that there will be a massive impact on local rates as you separate out AT&T from the local companies? We just do not know, as Commissioner Fogarty points out, how the valuation is going to be allocated or how we are going to unscramble all those eggs.

Chairman FOWLER. I think that it is fair to say we do not know for sure, but we believe. We do not at this time see any reason why the consent decree should have any material significant impact on local rates, with the caveat——

Senator SPECTER. How can you say that when you are going to have new companies with changing valuations and a very complex picture where there is good reason to believe there will be a tremendous impact on local rates?

Chairman FOWLER. The reason we say that is we do not see these activities involving either ratemaking or changes in the cost allocations. And those are the two forces that will affect your local rate structure.

If I may, I would like to have our chief here or Burt Halperin follow up with a little more technical discussion on that point.

Senator SPECTER. It seems to me that what you are doing is you are unscrambling one complex omelet with AT&T and local companies, and then you are throwing in two other omelets at least on the Federal-State Joint Board and another complex omelet on the deregulation pattern; and you can never really tell what was what.

Chairman FOWLER. I assure you, Senator, we are watching everything very carefully. We are accepting the guidance of Congress. One message we hear loud and clear from the Congress is we are concerned about the local rates. This agency has, in all of its activities, including these factors I cited here, where we have been making changes, been very careful to make them in a proper and smooth manner in order to lessen the precipitous nature of any local rate increases. Again, even when you are talking percentages, if the phone rate goes from $4.72 a month, basic charge, which I think is roughly what it is in D.C., to something double that or maybe even triple that over a period of several years, that still may turn out to be a bargain for that local consumer.

There are forces beyond our control, including inflation, that will mean that costs will go up, unfortunately. We do not take any great joy or delight in saying that.

I would like to ask Mr. Halperin——

Senator SPECTER. Chairman Fowler, I have to disagree with you when you talk about a bargain to the local consumer if the rates double or triple. I just cannot see any justification for that at all. The inflation factor does not remotely cause that kind of an increase. If you are talking about some structural changes otherwise, I think you are just plain wrong when you talk about a great bargain if you postulate a possibility of tripling local rates.

Chairman FOWLER. As I indicated, sir, if you just took a 10-percent inflation rate over 10 years compounded, that would be a 160-percent increase. That will have an effect. Labor goes up. The cost of material goes up. That cannot help but have some effect on what we all pay for. It is just one of those facts of life.

Senator SPECTER. That is not a trebling within 5 years. We also all know that the inflation rate is going to come way down, 4 percent——

Chairman FOWLER. I am suggesting that over the years it has been artificially held down to a low level, and those pressures are building and increasing. So, we are in a very unhappy position of attempting to keep local rates down as much as we can, but there are forces there that militate the other way. We have to be realistic about that. That is all I am saying.

Senator METZENBAUM. Why do you say they have been artificially held down?

Chairman FOWLER. The interstate long-distance telephone user, in effect, sir, to simplify this, perhaps oversimplify it, has subsidized what you pay for your local basic service over the years.

Senator METZENBAUM. I understand that part of the argument, and I am not even questioning it. But I suppose it also relates in part to how you allocate the cost of the capital equipment as to whether or not there is subsidization. You know, figures don't lie but liars can figure. You can play games with numbers. There is no business person anywhere who has not done it. It is just a question of how you make your allocations, how you set up, what you allocate to this or to that.

The fact is that saying to the American people that you are having divestiture—which, in essence, really is to emphasize the free competitive nature and let competition work—and then say, yes, but what we are doing in this divestiture has nothing to do with that free competition, and then to say that there has been the subsidization, and then to say that the local people are going to have their rates increased maybe three times in a short period of time, I think it is being rather unrealistic. It is almost as if we have our head in the clouds.

I think that is what concerns people. The FCC and the Antitrust Division have a responsibility to provide some protection to the public. This is what I think concerns the vast majority of the American people—they do not care about subsidization. They do not know about allocation. They only know that in the last analysis their rates are going up very substantially, and they cannot understand why because the phone service is no different. They understand if wages go up that they have to go up proportionally if other costs go up.

You are sitting here and saying to us, as a public official, that the FCC recognizes that rates are going to go up at an abnormally high percentage, maybe three times in 5 years, as the Chairman has pointed out, by reason of this divestiture.

What purpose then does the divestiture serve? All of us who felt that antitrust ought to permit competition to work are waking up and talking to ourselves and saying: Isn't it working wonderfully well; now everybody's going to pay more, and the local companies and the parent companies are all going to make more money and the American consumer is going to wind up being doused. Why? Let's forget about the divestiture. That's——

Chairman **Fowler**. Senator, I understand what you are saying. The first thing I wanted to say is we think the local phone rates might go up about 100 percent over 5 years, not 300 percent.

Senator **Metzenbaum**. Based upon an assumed 10 percent inflation rate or based——

Chairman **Fowler**. Not just inflation but a series of factors, inflation being one of the most important.

Senator **Metzenbaum**. And what else?

Chairman **Fowler**. Increased depreciation rates.

Senator **Metzenbaum**. Why should that occur? Why should somebody just say we are going to let you increase your depreciation rates? It does not make the P&L statement any different at all, I mean, unless you want to play games with it. It does not cost any more. The depreciation does not have to increase. That is an artificial figure.

Chairman **Fowler**. Yes, sir, but it reflects costs of equipment which over a period of time grows old and becomes obsolete, and it is a cost.

Senator **Metzenbaum**. I understand, but you always had depreciation.

Chairman **Fowler**. But in the past we had, we think, very unrealistic and outmoded and very slow rates of depreciation that did not take into account changes in technology and, in effect, made the ratepayer in the future pay for the costs of the use of the equipment by the ratepayer of the present. We thought that there was some way it should be devised to make that more of a reasonable, straight line depreciation rather than the way it was before when it was less than straight line.

Senator **Metzenbaum**. Did not I hear you say when I came in something about going from 20 years to 10 years to 1 year? Did I hear something about a 1-year depreciation?

Chairman **Fowler**. We are talking there about the expensing of station connections. I would like to ask Mr. Halperin here to comment a little bit more on what we did with depreciation.

Mr. **Halperin**. Senator, the basic reason for the Commission's going to the expensing of station connections is the fact that the environment we had before with these costs being capitalized, somebody, as you pointed out, sooner or later has to cover those costs. They do not disappear, and they cannot be confiscated from the company. If it actually costs $80 to do a rearrangement in my house but I am only charged $10 dollars for it and I have somebody who comes to visit me just for a week and I say is it worthwhile getting an extension phone put in there, well, if I am charged $10, I may say yes.

Senator METZENBAUM. I understand that fully. I have no problem with that.

Mr. HALPERIN. The only way we can move to insuring that people both recognize the cost they impose on the system by something like that and that the people who cause that cost pay for it is by expensing. The Commission may ultimately consider deregulation.

Senator METZENBAUM. You understand, my question has got nothing to do with that point that you are making.

Mr. HALPERIN. The switch from 20 to 1 was not a depreciation change of 20 to 1. It was a change in the philosophy of capitalizing those costs to expensing those costs.

In fact, the people who have to pay those costs are not the older rural people who, in fact, are much less mobile and do not remodel their house a lot and do not move a lot. The people who are causing those costs and throwing it back on the other people, were, by and large, the more upwardly mobile younger people who were buying new houses, remodelling the houses, putting on an addition for a new arrival or something. So, that changed. For the person who lives out on a farm somewhere and has the same phone service and wants the same phone service, that person will not pay one penny more.

Senator METZENBAUM. What I am asking you is, why are you permitting a change in the depreciation rates? AT&T in the past, if I am correct, depreciated at a low rate in order to increase their rate base. Now you are saying you are going to permit them to increase at a far greater rate, which will, in effect, cause the cost to the public to go up substantially. My question is, Why?

Mr. HALPERIN. There are two basic reasons, Senator. One is that it is necessary and it is very desirable, it is good policy to recover the costs of an investment over the time when that investment exists. If a switch or a wire somewhere is junked and 80 percent or 70 percent of the costs of that wire are left to be recovered by somebody in the future, the point will come when there is a huge pool of costs and no one willing to pay them.

The second is——

Senator METZENBAUM. Wait just a minute. Has that occurred? AT&T has been in business a long time. They have been recovering their costs. Their profits have soared in recent years. They do not seem to be hurting as a company. You are telling us that somehow that is going to catch up with them. Where? When? How?

Mr. HALPERIN. Senator, that has to do with the second reason. In fact, there has been this huge pool of costs that has been pushed off to be recovered in the future. It is trying to amend that as we move into the era of competition where one person cannot be burdened with $5, $10 billion of costs that they have to recover today but where someone who is getting into the business and not burdened with that could undercut them. So, it is necessary in the competitive era to see a match of the capital recovery with the life of the plant.

Senator METZENBAUM. Nobody can argue about the fact of having capital recovery equal to the life of the plant. I mean, are you saying if the equipment is no longer operable or at the end of 10 years you ought to have a 10-year depreciation? I do not hear you saying that. I hear you talking about a 1-year base. I hear you talking about 1 year and the question of every time there is a connection made. And it is a totally different concept. When you make an installation at a new home, you are talking about recovering that in 1 year, if I understand what you are saying.

Chairman FOWLER. But most of those costs are labor costs, Senator, as we explained.

Senator METZENBAUM. What difference does that make? We always had that. Every time we build this building there are labor costs——

Chairman FOWLER. It would seem more logical, though, would it not, to expense it?

Senator METZENBAUM. When you have an oil well drilled you have labor costs.

Chairman FOWLER. Yes, sir, but would not it seem more logical to expense that in the year that the labor is performed than to capitalize it and extend it over many years? That is what we are saying.

Senator METZENBAUM. Mr. Chairman, may I just say to you that it does not happen anywhere in American industry, with one exception, and that is in the oil industry. They were given a special right to write off their intangible drilling costs in the first year. And all the rest of industry winds up paying their taxes for them. Now you are coming in and making the same proposal for AT&T.

The question that I have is this. Why are you proposing it? Every other industry has the same factor of labor costs with respect to capital improvements. Why should you single out the telephone company in order to give them this preferential method of writeoff?

Mr. HALPERIN. Sir, with respect to plant investments, we are doing what you suggest, which is to match the depreciation with the life of the plant. But today, if you go out in the areas where you can, many States you can, and have an electrician wire your house instead of the phone company, you pay that electrician for the price he has to pay his workmen to go out and do it. We are treating AT&T exactly the same as that. Right now, if you have two choices, go to the phone company or go to an electrician and get the wiring, we are saying you should pay for it in the same way. That is fair competition.

Senator METZENBAUM. Are there States that permit you to make your own installation of your telephone equipment?

Mr. HALPERIN. Yes, sir.

Senator METZENBAUM. Not in my State, certainly one of the bigger States.

Mr. HALPERIN. There are States. In fact, today we have been told by our experts back there, there is a lot of wiring you can do yourself. You could probably add a new extension yourself in a great many jurisdictions.

Senator **METZENBAUM**. Then you would have to pay so much a month for using it?

Mr. **HALPERIN**. Yes, sir, but that would be for the dial tone service. If you did it yourself, I do not even think the phone company would try and charge you for that labor.

Senator **METZENBAUM**. I will not try that.

Senator **SPECTER**. Senator Leahy, would you like to question?

Senator **LEAHY**. No, Mr. Chairman.

Senator **SPECTER**. We would like to move on to the next panel. This is a fascinating subject. It is extraodinarily involved. We have a very large number of witnesses. We very much appreciate your coming, Chairman Fowler and Commissioner Fogarty, Mr. Epstein, and Mr. Halperin. Thank you. We will look forward to the supplemental materials.

Chairman **FOWLER**. Thank you. Sir, may I say you have asked some very excellent questions and pressed us pretty hard. I think that is the way it should be.

Senator **SPECTER**. Thank you very much. I would next like to call the Honorable Bernard J. Wunder, Jr., Assistant Secretary of Commerce for Communications and Information, the Department of Commerce.

[Prepared statements follow:]

STATEMENT
OF
COMMISSIONER JOSEPH R. FOGARTY
FEDERAL COMMUNICATIONS COMMISSION
before the
SENATE COMMITTEE ON THE JUDICIARY
on the
1982 AT&T/DEPARTMENT OF JUSTICE CONSENT DECREE

March 25, 1982

Mr. Chairman and Members of the Committee:

I appreciate this opportunity to share with you my views on the effects and implications of the agreement reached between the American Telephone and Telegraph Company (AT&T) and the Department of Justice (DoJ) to vacate and replace the 1956 AT&T Consent Decree. Before addressing the particular area of interest to the Committee in these hearings--the impact of the proposed 1982 Consent Decree on local telephone service and rates and on the viability of the divested Bell Operating Companies (BOCs)--I would first offer brief comment on the AT&T/DoJ agreement from the perspective of the mandate and responsibilities of the Federal Communications Commission (FCC) under the Communications Act of 1934.

It is perhaps an understatement to note that the proposed 1982 Consent Decree is of momentous significance for this nation's telecommunications policy. It is, however, no overstatement to suggest that the new Consent Decree raises serious questions regarding the FCC's continuing statutory responsibilities and authority with respect to the formulation and implementation of that policy. In this regard, it must be recognized that the FCC's regulatory jurisdiction over telecommunications is primary, and that while the law favors accommodation of both the regulatory and antitrust regimes, in cases of irreconcilable conflict it is the antitrust law which must yield to the regulatory agency's broader mandate. The reason for this primacy of FCC jurisdiction is plain: the Communications Act requires the FCC to base its actions on findings made in accordance with the statutory standard of the "public interest, convenience, and necessity;" by contrast, the antitrust laws look solely to competition as the safeguard of the public interest. While competition is a component part of our regulatory standard--and is accorded great weight by the Commission--it is not the whole of the public interest standard. The FCC's mandate is not merely to promote competition or simply to balance equities among competitors, but rather to determine how best to provide telecommunications service to the public. As the Supreme Court has recognized:

> The very fact that Congress has seen fit to enter into the comprehensive regulation of communications embodied in the Federal Communications Act of 1934 contradicts the notion that national policy unqualifiedly favors competition in telecommunications.
> . . . .
> What may substantially lessen competition in those areas where competition is the main reliance for regulation of the market cannot be automatically transplanted to areas in which active regulation is entrusted to an administrative agency; . . . what competition is and should be in such areas must be read in light of the special considerations that have influenced Congress to make specific provision for the particular industry. FCC v. RCA Communications, Inc., 346 U.S. 86, 93, 98 (1953).

While the immediate parties--AT&T and DoJ--are apparently satisfied that the proposed decree modification is an appropriate resolution of their litigation under the antitrust laws, it remains to be seen and determined whether the new Consent Decree will also serve the larger public interest in accordance with the Communications Act and be consistent with the FCC's statutory authority and responsibilities.* The Commission has been studying the proposed Decree from this perspective and intends to participate fully in the judicial review process as an amicus curiae. The Commission has also been engaged in an ongoing informal consultative process with the Justice Department to clarify the meaning, intent, and effect of the 1982 Consent Decree in particular as well as generality. The Justice Department's February 10, 1982 filing of its "Competitive Impact Statement" marked the beginning of this clarification process. In this regard, I was pleased to note that the Department intends, during the period prior to the submission of the AT&T reorganization plan, to work closely with interested parties, including the Department of Defense, the FCC, and State regulators, to draw upon their expertise, and also to become thoroughly familiar with their concerns. I believe that the FCC can and will play a constructive and collegial role in advising the Justice Department and the court of our concerns with respect to the substance and effects of the proposed Decree. To this end, the Commission yesterday provided an en banc meeting forum for some thirty parties to comment on the relationship of the settlement agreement to the Communications Act and to the FCC's public interest mandate, and later today the Commission will meet to begin the formulation of its amicus curiae views.

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* For the Committee's further information, I am attaching a copy of a memorandum, which I circulated to the Commission, detailing my concerns with respect to apparent impacts of the proposed decree on FCC jurisdictional interests.

It may be that the settlement reached by AT&T and DoJ will serve the larger public interest in telecommunications, as well as antitrust policy interests. The overview I present here should not suggest that I would have the FCC address itself to the new Consent Decree in other than a spirit of intergovernmental collegiality and respect for the province and authority of the antitrust suit court. I believe the Commission will strive to recognize and accommodate the agreement of the parties under the antitrust law regime consistent with our own independent statutory responsibilities and prerogatives. However, just as the Department of Justice has made it clear--and properly so--that it intends to maintain the primacy of its antitrust policy judgments with respect to the proposed Decree, so must the FCC be mindful that the Congress has assigned to us the primary responsibility for the formulation and implementation of national telecommunications policy in the public interest.

Turning to the subjects of immediate interest to the Committee in these hearings, I note that the announcement of the proposed Consent Decree has been met by a virtual ground swell of concern regarding the impact of the Decree on local telephone service and rates. I think this concern is both legitimate and compelling. The national interest in maintaining rapid, efficient telephone service with adequate facilities and at reasonable charges affordable by all Americans is as critical today in 1982 as in 1934 when these fundamental principles were first recognized and enacted by Congress in Section 1 of the Communications Act. In fact, with the advent of the "Information Age," and with an ever-increasing share of our Gross National Product attributable to the production, dissemination, and use of information and associated technology, goods, and services, these policy principles become all the more crucial to our national welfare. In my judgment, we cannot afford to become a nation of "haves" and "have nots" in terms of fair and reasonable access to the telecommunications services which are essential to full participation in our commercial, political, and social life. A democratic society ignores any threat of such disparities at its peril.

While I therefore agree that the general concern regarding the possible impact of the proposed Decree on local telephone service and rates is an important one, I must also observe that it is not easy to assess or predict the actual local service and rate impacts which may be involved. It first must be recognized that before the proposed settlement was announced, upward pressures on local telephone rates were already the likely result of several FCC pro-competitive actions, including the deregulation of customer premises equipment mandated by the Commission's Computer Inquiry II decision and the adoption of expensing of station connections, as well as decisions permitting accelerated depreciation. The FCC and the States are currently engaged in Joint Board proceedings to ease through transition the local rate impacts of these decisions through changes in the separations procedures governing interstate/intrastate cost allocation and revenue contribution. While it may be technically correct to state that the proposed Decree in and of itself will not be an independent or direct cause of upward local rate pressures, I think it clear that the Decree will add a complicating overlay on this area of concern.

When the local BOCs are divested according to the terms of the Decree, their revenue requirements, on which their local rates must be based, will be substantially affected by the valuation and transfer of plant, terminal equipment, and other assets between the local companies and AT&T. To effectuate the divestiture provisions of the Decree, interstate and intrastate toll facilities and customer premises equipment must be valued and transferred from the operating companies to AT&T, and assets used by AT&T and Bell Telephone Laboratories for the provision of local exchange service must be valued and transferred to the operating companies or to the entity that will provide centralized coordination for the BOCs for purposes of national security and emergency preparedness. If the transfer of assets from AT&T to the BOCs is valued too high, the BOCs may be unfairly burdened with higher revenue requirements which will have to be matched by higher rates for local exchange or exchange access services. Conversely, if the transfers from the BOCs to AT&T are valued too high, intrastate and interstate toll services may be unfairly burdened. On the other hand, if the BOC assets to be transferred to AT&T are valued too low, then the local companies and their ratepayers will not only lose the gains which should properly accrue to their benefit in the form of revenues for plant modernization and debt servicing and lower rates; they will have also provided AT&T with an undue subsidy to their detriment and the detriment of AT&T's competitors. The asset valuation and transfer process will therefore be critical in establishing a fair and accurate revenue requirement for the divested BOCs in their local exchange service operations. The FCC must play an essential and primary role in this process, and must have the resources to accomplish its responsibilities effectively and promptly.

The revenue requirement which local exchange service rates must bear will also be affected by the allocation of local exchange plant and expenses between the interstate and intrastate jurisdictions and, under the structure of the Decree, between local exchange and local exchange access services. Under the Communications Act and the principles of Smith v. Illinois, 282 U.S. 133 (1930), the FCC must allocate by separations procedures the BOC local exchange plant between the interstate and intrastate jurisdictions, so long as the Commission continues to have end-to-end authority over interstate services. This FCC authority would appear to include responsibility for determining the local exchange access charges for interstate services which are mandated by the Decree as a substitute for the existing division of revenues process. The allocation of local exchange facilities and expenses between local exchange service and exchange access for intrastate services appears to be primarily, if not exclusively, within the jurisdiction of the State commissions.

Local exchange service revenue requirements for the divested BOCs--and hence local rate levels--will be impacted by these allocation procedures and separations processes, but the specific impacts and their magnitudes cannot be predicted with any certainty at this time. As I previously noted, FCC decisions concerning the deregulation of customer premises equipment, the adoption of expensing of station connections, and accelerated depreciation are expected to exert significant upward pressures on local rates. If these pressures are to be contained or minimized, the basic options appear to be few.

The way State commissions may determine and allocate revenue requirements for local exchange and intrastate toll services is directly affected by the proposed Consent Decree. Because the Decree mandates wholly separate entities for the provision of local exchange and intrastate toll services, requires tariff unbundling, and forbids revenue/profit pooling, State regulators will no longer have the flexibility and discretion to allocate a single revenue requirement between these services. While the State Commission will have jurisdiction over intrastate access charges, that potential source of local exchange contributions appears limited in view of the lower volume of intrastate toll traffic compared with that of interstate toll. Moreover, because revenue requirements for intrastate toll tend to be greater than those for interstate toll due to the shorter haul over older, higher unit cost facilities, it seems doubtful whether the States can look to those services for any significant additional contribution to the maintenance of local exchange rates.

By a process of elimination, it appears that the focus of concern with respect to alleviating local rate increases will have to be on the interstate/intrastate separations process and the system of interstate exchange access charges. There has been initial concern that the Decree's requirement of "cost based" exchange access charges would preclude any subsidy designed to support and further universal service objectives. However, the Competitive Impact Statement filed by DoJ states that the Decree

> "does not prevent appropriate regulatory or legislative authorities from requiring that the exchange access charges or any other mechanism prescribed by regulatory authorities be utilized as vehicles for payments to the BOCs of costs allocated to exchange access by jurisdictional separations, or, in the case of apportionment between services subject to regulation by an individual state, by state regulatory authorities."

While the precise meaning and practical implications of this statement are not entirely clear, it appears that the Department thereby recognizes that the Decree cannot supersede the separations process mandated by the Communications Act and will not affect the authority and discretion of the FCC and the States in prescribing the cost allocations on which the exchange access charges will be based. This recognition would therefore leave intact whatever authority the FCC has to prescribe some form of interstate subsidy for local exchange service where warranted on public interest policy grounds. Nonetheless, with the expansion of interstate and information service competition, the separations and exchange access charge proceedings are likely to be highly contentious, and the FCC's discretion to structure a system of deliberate subsidies for local exchange service at variance with straight cost-allocation principles may be tested. At the same time, there may be pressure to allocate more of what are now considered interstate costs to the intrastate side, thereby increasing the revenue requirements to be borne by local rates. Thus some parties, including interexchange competitors, have argued that all usage insensitive equipment should be allocated to the intrastate or local exchange jurisdictions to be expensed or otherwise borne entirely by those jurisdictions. Changes in separations procedures in this direction would clearly exert substantial additional upward pressures on local rates. Legislation may be necessary to establish or clarify the appropriate mandate and discretion of the FCC in this critical area.

While the proposed Consent Decree would not appear to be a direct and independent cause of upward local rate pressures, certain indirect effects may be anticipated. The additional competitive pressures stimulated by the Decree may impact on telephone rates in higher cost rural regions. Revenues from toll calls into and from a particular rural exchange may be supporting that exchange's local service. In some States, this toll-towards-exchange support or subsidy is averaged across carriers' statewide operations, while in other States, or where single exchange smaller companies are involved, this support is at the single exchange level. A system of access charges, as contemplated by the Decree, might be structured to retain this support. However, it is possible that the effect of such a system of artificially inflated (with respect to cost) support would be to depress toll calling into and from a given exchange so as to make this method of contribution counterproductive. To the extent that the present system in effect causes these contribution burdens to be borne in part by users of high capacity urban services, the burdens are spread among a broader number of ratepayers and thus the system does not explicitly penalize calling to and from rural regions. The Consent Decree may prompt a more disaggregated structure which could assign higher burdens more explicitly to calls from and to rural exchanges with no support from urban ratepayers and thereby depress the level of rural toll calling.

The proposed Consent Decree may also affect AT&T's current rate averaging practices which have the effect of supporting toll services from and to rural exchanges (as well as providing support from toll towards local exchange service). Such support is evident in the case of toll calls between urban areas over high-capacity interexchange facilities (e.g., Washington, D. C. to Boston) and may also be involved in toll calls between urban areas and rural areas (e.g., Washington, D. C. to Pensacola, Florida). Toll calling between rural areas (e.g., Ogden, Utah to Pensacola, Florida) is the clear recipient of such support. With increased toll service competition, it is possible that at some point AT&T may attempt to abandon this supporting rate averaging.

Although these impact scenarios are at this time necessarily speculative, it is possible that the Decree will result in a new telephone industry structure which may change or limit the alternatives available to the FCC to maintain support for rural service. The Commission is currently studying the potential impact of the Decree on rate averaging (which is the result now of carrier-initiated tariffs) and the compensation of individual exchanges based on their costs rather than the revenues attributable to their service. It may be that there are additional costs in providing interexchange service in rural areas, and that for the use of non-traffic sensitive plant interexchange carriers should pay an access surcharge above charges based on pure usage factors. This does appear to be an area in which the Decree will have a significant, albeit indirect, effect on local rates and on rates for toll calling to and from rural regions.

Moving from the matter of rate impacts to the question of the overall financial and technical "viability" of the BOCs post-divestiture, it is difficult to offer definitive comment until the specific AT&T reorganization plan for divesting the BOCs is presented. (The proposed Decree provides that AT&T's reorganization plan is to be submitted six months after its effective date.) The DoJ Competitive Impact Statement indicates the Department's intention that "its review of AT&T's plan of reorganization will insure that the divested portions of the BOCs are given all assets necessary to perform their designated telecommunications functions and have sufficient resources to remain financially and technically viable enterprises." This, of course, merely states the critical issue.

The matter of BOC "viability" is critical because if upon divestiture the local exchange companies are perceived as a less desirable investment than AT&T is today, their cost of capital may increase in the future. Cost-of-capital increases may raise the required rates of return of the BOCs, thereby forcing service rate increases. From this perspective, the term "viable" is perhaps an ill-advised standard because if the divested local exchange companies are capitalized in a manner that is barely sufficient to ensure their viability, these untoward cost of capital and rate of return effects are likely to occur. In this regard, early predictions from bond market analysts give some cause for concern in terms of indicating probable down-ratings of local company debt issues. These observations make the asset valuation and transfer process necessary to effectuate the divestiture Decree all the more crucial.

Equally critical and fundamental is the issue of the proper role of the divested BOCs in the future world of telecommunications. Under the terms of the Decree, the BOCs will be limited essentially to providing local exchange and inter-exchange access services and will be precluded from providing interexchange service and so-called "information services." In essence, these companies will be restricted to providing only dial tone. While the "bottleneck" analysis on which these restrictions are based may appear pristine as a matter of antitrust theory, I must seriously question the wisdom and appropriateness of the constraints imposed on the BOCs from several larger public interest perspectives.

First, restricting the BOCs to local exchange and interexchange access services in the face of the likely revenue requirement impacts previously discussed will only make it more difficult to maintain reasonably affordable basic telephone service.

Second, to restrict the BOCs in the manner prescribed by the proposed Decree will be to deny consumers the benefit of securing high quality, low cost enhanced services integrated in the local loop technology of the telephone exchange. The FCC's Computer Inquiry II decision would limit the divested BOCs to "basic" or "pipeline" services but also provides for waivers permitting the integrated provision of "enhanced" services upon a showing of significant technical advantages or cost economies benefitting consumers. While DoJ's Competitive Impact Statement suggests that the divested BOCs may petition for modifications of the Decree according to changing technical, competitive, and regulatory conditions, I question whether this avenue provides sufficient flexibility given the narrow antitrust focus of the Decree and the cumbersome nature of any modification process.

Third, the restrictions imposed by the proposed Decree on the divested BOCs raise serious and fundamental questions concerning the adequacy of BOC research and development and the prospect for continued progress in local exchange technology and services. If the BOCs are restricted to the limited market for exchange and access facilities, it is doubtful whether they will be in a financial position to support any significant research in local loop technology. Given the increased pressures on State regulators to keep basic local exchange rates low, it seems all too likely that capital for such R&D will not be forthcoming unless immediate and significant revenues can be expected from the development and deployment of new and improved technology. While the BOCs will be free to replace their existing copper wire local loops with new broadband fiber-optic cables, they will be constrained to provide only the facilities and will be precluded from participating in the market for the information services to be offered over those facilities. Under these circumstances, it is likely that either State regulators will refuse to sanction the capital commitment and revenue requirement necessary for the construction of broadband facilities, or information and other special services will have to bear fully compensatory or even excessive access charges. In the first case, plant modernization would be retarded, and in the second, new services would be inhibited. Neither result would be in the public interest. Similar untoward effects may be anticipated in the field of electronic switching and other local loop equipment. After divestiture, the prohibition on BOC marketing of new services may make the local operating companies hesitant or reluctant to experiment with more advanced switching and equipment designs. This result would also be in sharp conflict with the larger public interest.

While innovation will not cease as a consequence of the Decree's restrictions on the BOCs, the operating companies will no longer lead the world in telephony and allied fields. I think it a likely result that in many instances new telecommunications technology and services will be introduced more quickly and effectively in other countries than in the United States. The implications for U.S. industry competitiveness in world telecommunications markets are no less troublesome.

The proposed Consent Decree appears to assume that the risks entailed in restricting the operations of the divested BOCs are outweighed by the prospect of enhanced competitive status for other equipment and service providers in the telecommunications marketplace. I am not so confident that this policy calculus is correct. In my judgment, it is a strange "pro-competitive" policy that locks a particular set of potential competitors out of any marketplace. There are other remedies, short of outright prohibition, for the so-called "bottleneck" problem--strict accounting and tariff regulation or separate subsidiary structure where necessary. Of course, these alternatives may be difficult, if not impossible, to implement in the form of an antitrust consent decree. However, I believe these alternatives would far better serve the larger public interest in maintaining the "viability" of the BOCs and in enhancing the universal availability of their facilities and the services provided over them. For these reasons, I think sound public policy would be best served by deleting altogether the Decree's restrictions on the divested BOCs. As a less desirable alternative, the Decree should be modified so that the BOC restrictions expire on an early date certain--i.e., within one to two years after its effective date.

In summary, while the proposed Consent Decree would not appear to be an independent or direct cause of upward local rate pressures, it will complicate ongoing efforts to ease the local rate impacts occasioned by FCC pro-competitive decisions and may be an indirect source of local rate pressures in rural exchanges. The Decree does present serious questions concerning the technical and financial viability of the BOCs after divestiture. By imposing onerous restrictions on BOC operations, the Decree will make those concerns regarding BOC technical and financial viability critical and more difficult to allay. The Decree must be closely scrutinized from this perspective, and, in my judgment, it must be significantly modified to ensure that the BOCs will serve the public interest in the future as they have in the past.

I thank the Committee for the opportunity to submit this statement, and I hope these views will be of assistance in your review of the proposed 1982 AT&T/DoJ Consent Decree.

TESTIMONY
OF
MARK S. FOWLER, CHAIRMAN
FEDERAL COMMUNICATIONS COMMISSION

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE

THANK YOU FOR EXTENDING THIS INVITATION TO TESTIFY ABOUT THE PROPOSED SETTLEMENT OF THE AT&T/ DEPARTMENT OF JUSTICE ANTITRUST PROCEEDING AND ABOUT WHETHER THERE IS A NEED FOR LEGISLATION TO AMEND THE COMMUNICATIONS ACT OF 1934 AT PRESENT. MY TESTIMONY THIS MORNING WILL FOCUS ON THE EFFECT, IF ANY, OF THIS PROPOSED SETTLEMENT ON LOCAL TELEPHONE RATES.

THE PROPOSED CONSENT DECREE SEPARATES REGULATED "BOTTLENECK" LOCAL BELL OPERATING COMPANY (BOC) SERVICES, SUCH AS LOCAL EXCHANGE SERVICE, EXCHANGE ACCESS AND ADDITIONAL "MONOPOLY" OFFERINGS MADE UNDER TARIFF, FROM THE RESTRUCTURED AT&T. THE AGREEMENT PROVIDES THAT THE BOCS CANNOT DISCRIMINATE IN INTERCONNECTING INTEREXCHANGE SERVICES OFFERED BY AT&T AND ITS COMPETITORS. THE NEW AT&T, STRIPPED OF CONTROL OF THESE BOTTLENECK FACILITIES, MAY ENGAGE IN TELECOMMUNICATIONS SERVICES, TERMINAL EQUIPMENT OFFERINGS AND UNREGULATED ACTIVITIES WITHOUT RESTRICTION UNDER THE PROPOSED DECREE. TO IMPLEMENT THE AGREED UPON DIVISION BETWEEN AT&T AND BOC ACTIVITIES, AT&T WILL BE REQUIRED TO DIVEST ITS OWNERSHIP OF THE BOCS TO AT&T'S SHAREHOLDERS.

DURING THE PAST TWO MONTHS THE FCC HAS CAREFULLY ANALYZED THE PROPOSED SETTLEMENT TO DETERMINE HOW ITS TERMS MESH WITH OUR PRO-COMPETITIVE VIEWS AND PUBLIC INTEREST MANDATE UNDER THE COMMUNICATIONS ACT OF 1934. WE ALSO SPONSORED AN EN BANC MEETING YESTERDAY TO SOLICIT THE VIEWS OF INTERESTED PARTIES ON THIS SUBJECT. WE SHALL PARTICIPATE IN

THE TUNNEY ACT PROCEEDINGS AND SHALL FILE AN AMICUS BRIEF WITH JUDGE GREENE.

THE VOLUNTARY AGREEMENT OF THE DEPARTMENT OF JUSTICE AND AT&T IS, I BELIEVE, A MAJOR POSITIVE STEP TOWARD PROMOTING NEW FORMS OF COMPETITION. THEREFORE, I ENDORSE REMOVAL OF 1956 CONSENT DECREE RESTRICTIONS UPON AT&T'S ACTIVITIES. FURTHERMORE, BY SEPARATING BELL SYSTEM LOCAL EXCHANGES FROM ITS LONG DISTANCE ENTITY, THE DECREE CHANGES CORPORATE INCENTIVES IN PRO-COMPETITIVE WAYS. LOCAL EXCHANGE COMPANIES WILL NO LONGER HAVE THE SAME INCENTIVES TO FAVOR AT&T LONG LINES FOR INTERCONNECTION OF SERVICE OR TO PURCHASE FROM WESTERN ELECTRIC. I INTEND TO URGE THE COMMISSION TO FACILITATE IMPLEMENTATION OF THE DECREE INSOFAR AS, IN ITS FINAL FORM, IT EMBODIES AND IS CONSISTENT WITH OUR PUBLIC INTEREST GOALS. WHERE WE HAVE QUESTIONS ABOUT THE PROPOSAL, SUCH AS ITS LIMITATION ON ACTIVITIES OF LOCAL EXCHANGE COMPANIES, THE COMMISSION SHALL ATTEMPT TO RESOLVE THEM.

THE EFFECT OF THE PROPOSED DECREE ON LOCAL TELEPHONE SERVICE RATES HAS BEEN THE SUBJECT OF MUCH SPECULATION. LOCAL RATE LEVELS INVOLVE COMPLEX INTERRELATIONSHIPS. THEY BRING INTO PLAY THE ARCANE SUBJECT OF JURISDICTIONAL SEPARATIONS. AND, OF COURSE, THEY HAVE SIGNIFICANT IMPACT ON MOST AMERICAN CONSUMERS' POCKETBOOKS. IT IS NOT SURPRISING, THEREFORE, THAT SUCH AN IMPORTANT AND DIFFICULT-TO-UNDERSTAND SUBJECT SHOULD GIVE RISE TO MISCONCEPTIONS. I HOPE TO DISPEL TWO SUCH MISCONCEPTIONS THIS MORNING.

THE FIRST IS THAT THE CONSENT DECREE WILL CAUSE A PRECIPITOUS INCREASE IN LOCAL RATES. THE SECOND IS THAT THE FCC IS SOMEHOW IRRESPONSIBLY CAUSING INCREASES IN LOCAL RATES.

THE COMMON CARRIER BUREAU STAFF'S PRELIMINARY ANALYSIS OF THE EFFECTS OF THE PROPOSED DECREE INDICATES THAT THE LOCAL

RATE QUESTION, WHILE AN IMPORTANT ISSUE, IS NOT CRITICALLY AFFECTED BY THE PROPOSED DECREE. IT IS OTHER PRESSURES, SUCH AS INFLATION, INCREASED DEPRECIATION RATES, TERMINAL EQUIPMENT DEREGULATION, CHANGES IN SEPARATIONS AND EXPENSING OF STATION CONNECTIONS THAT ARE CHIEFLY INVOLVED.

A FIRST AND CRITICAL CAUSE OF INCREASED LOCAL RATES IS THE GNAWING INFLATION WE ALL FACE. AS THE COST OF DEBT AND EQUITY CAPITAL RISES, AND THE COST OF LABOR INCREASES, RATES EVENTUALLY MUST FOLLOW. THE COMMISSION, FOR EXAMPLE, HAS RECENTLY REAFFIRMED AT&T'S 12.75% RATE OF RETURN, A RATE WHICH SOME NOW VIEW AS CONSERVATIVE. A SIMPLE FACT OF LIFE IS THAT A 10% INFLATIONARY INCREASE IN COSTS COMPOUNDED YEARLY FOR 10 YEARS BY ITSELF WILL RESULT IN APPROXIMATELY A 160% COST INCREASE.

A SECOND IMPORTANT FACTOR AFFECTING LOCAL RATES IS THE COMMISSION'S SIGNIFICANT MODIFICATIONS IN ITS DEPRECIATION POLICIES. ALL ACCOUNTING MEASURES ARE IMPORTANT, BUT IN A CAPITAL INTENSIVE INDUSTRY LIKE TELECOMMUNICATIONS THE MEASURE OF DEPRECIATION BECOMES EVEN MORE CRITICAL.

OUR PAST PROCEDURES PROVIDED INADEQUATE CAPITAL RECOVERY FOR TWO REASONS: LIFE ESTIMATES WERE TOO LONG AND DEPRECIATION PROCEDURES WERE DESIGNED TO RECOVER MORE COSTS IN LATER YEARS. THESE PROCEDURES HAD THEIR ATTRACTION IN THE DAYS OF A RELATIVELY STABLE TECHNOLOGICAL ENVIRONMENT. STRETCHING OUT LIFE ESTIMATES WAS AN ACCEPTABLE WAY OF MAINTAINING LOWER RATES.

BUT WE ARE NOW IN A DYNAMICALLY CHANGING ENVIRONMENT, PARTLY ALTERED BY COMPETITION, BUT MOSTLY BY THE ASTOUNDING ACCELERATION OF INNOVATION AND NEW TECHNOLOGIES. WHAT WE HAD UNDER EARLIER DEPRECIATION PROCEDURES WAS A SIGNIFICANT INSTANCE OF UNDER-ACCRUAL. THE PROBLEMS CAUSED BY OVERESTIMATION OF SERVICE LIVES WERE COMPOUNDED BY DEPRECIATION PROCEDURES THAT TENDED

TO UNDERSTATE THE COST BURDEN FOR PRESENT CUSTOMERS. AS A RESULT, THE RECOVERY OF SOME COSTS, INCURRED BY PRESENT CUSTOMERS, WAS DEFERRED FOR PAYMENT BY FUTURE CUSTOMERS. WE BELIEVE OUR NEW DEPRECIATION POLICIES WILL IMPROVE THE TECHNICAL AND ECONOMIC RESILIENCE OF THE INDUSTRY, AND CORRECT THE DISTRIBUTION OF COSTS BETWEEN PRESENT AND FUTURE RATEPAYERS.

THE THIRD UPWARD FORCE ON THE COST OF LOCAL SERVICE IS DEREGULATION OF TERMINAL OR CUSTOMER PREMISES EQUIPMENT, AS PART OF OUR COMPUTER II DECISION. COMPETITION AND TECHNOLOGICAL DEVELOPMENT IN TERMINAL EQUIPMENT MARKETS, ESPECIALLY IN THE BUSINESS MARKET, IS BURGEONING. THIS BOOM IN THE TERMINAL EQUIPMENT MARKET MAKES DEREGULATION OF CPE NECESSARY. BUT DEREGULATION OF CPE ALSO NECESSITATES ITS REMOVAL FROM THE "SEPARATIONS PROCESS." THE "POPENOE PLAN" FOR REMOVING CPF FROM SEPARATIONS, ADOPTED BY THE COMMISSION ON FEBRUARY 24, MITIGATES THE EFFECT OF CPE REMOVAL ON LOCAL RATES.

SEPARATIONS IS THE METHOD USED IN THE TELEPHONE INDUSTRY TO ALLOCATE INVESTMENT IN PLANT AND THE EXPENSES OF PROVIDING SERVICE BETWEEN THE INTRASTATE AND INTERSTATE JURISDICTIONS. ONCE THE DEREGULATION OF CPE HAS TAKEN PLACE, IT WILL NO LONGER BE NECESSARY TO ALLOCATE SUCH EQUIPMENT BETWEEN THE TWO JURISDICTIONS. MOREOVER, REMOVAL OF CPE FROM THE PROCESS IS IMPORTANT TO PREVENT THE CONTINUED BURDENING OF INTERSTATE CUSTOMERS WITH THE COST OF EQUIPMENT THEY MAY NOT USE.

SEPARATIONS ISSUES ARE COMPLEX, BUT THEIR RESOLUTION IS CRITICAL TO ALL WE ARE TRYING TO DO AT THE COMMISSION. THE PROCESS IS COMPLICATED BY THE NATURE OF OUR TELEPHONE SYSTEM, AN INTEGRATED NATIONWIDE NETWORK SUBJECT TO BOTH STATE AND FEDERAL REGULATORY JURISDICTIONS. THE PROCESS IS FURTHER COMPLICATED BY THE PRESENCE OF JOINT AND COMMON COSTS. IN FACT, THE VAST MAJORITY OF LOCAL EXCHANGE COSTS ARE SHARED JOINTLY BY LOCAL AND INTER-EXCHANGE SERVICES. A MAJOR GOAL THEN, AND ONE WHICH IS BEING TACKLED BY A JOINT BOARD OF FEDERAL AND STATE COMMISSIONERS, IS TO FIND THE MOST EFFICIENT AND EQUITABLE METHOD OF ALLOCATING THESE COSTS BETWEEN THE INTRASTATE AND INTERSTATE JURISDICTIONS.

TRADITIONALLY, JOINT AND COMMON COSTS HAVE BEEN ALLOCATED ON THE BASIS OF MINUTES OF USE. BUT, ONCE THE INTERSTATE USAGE IS IDENTIFIED, A FORMULA IS APPLIED WHICH, IN EFFECT, MULTIPLIES THIS USAGE BY A FACTOR OF APPROXIMATELY THREE. IN OTHER WORDS, LONG DISTANCE BEARS OVER THREE TIMES THE JOINT AND COMMON COSTS THAT WOULD OTHERWISE BE ALLOCATED ON A STRICT RELATIVE USE BASIS. THIS FORMULA FOR COST ALLOCATION IS OBVIOUSLY NOT THE PRODUCT OF STRICT ACCOUNTING METHODS. RATHER, IT WAS A METHOD CHOSEN TO ACCOMMODATE VARIOUS SOCIAL, POLITICAL AND ECONOMIC CONCERNS. OVER TIME, THOUGH, AS MORE AND MORE PEOPLE USE LONG DISTANCE SERVICE, AN EVER INCREASING POTENTIALLY UNREASONABLE PERCENTAGE OF THE JOINT AND COMMON COSTS HAS BEEN ALLOCATED TO INTERSTATE.

OUR MAJOR GOAL IN THE JOINT BOARD PROCEEDING IS TO DEVELOP PROCEDURES THAT PROVIDE A MORE ACCEPTABLE LEVEL OF COST ALLOCATION TO SERVICES IN EACH JURISDICTION SO THAT MORE EFFICIENT USE CAN BE MADE OF THE TELEPHONE NETWORK. CHANGES IN THE SEPARATIONS PROCESS, EVEN IF THEY ARE TEMPERED BY MEASURES TO CONTINUE SOCIALLY DESIRABLE SUBSIDIES, MAY ALSO CREATE UPWARD PRESSURE ON LOCAL RATES.

FINALLY, ABOUT A YEAR AGO THE COMMISSION VOTED TO MANDATE THE EXPENSING OF STATION CONNECTIONS, AND THIS EXPENSING ALSO RAISES LOCAL RATES. "STATION CONNECTIONS" ARE THE WIRES FROM YOUR HOUSE TO THE TELEPHONE POLE OUTSIDE--A "BIG TICKET" ITEM IN TELECOMMUNICATIONS SERVICE. PRIOR TO THIS DECISION STATION CONNECTIONS HAD BEEN CAPITALIZED.

THIS SHIFT IN POLICY GREW OUT OF A PRINCIPLE ESTABLISHED AFTER A GENERAL INVESTIGATION INTO AT&T'S RATES--THAT THE BURDEN

OF STATION CONNECTION COSTS SHOULD BE PLACED ON THE RATEPAYER RESPONSIBLE FOR THEM, RATHER THAN ON ALL RATEPAYERS, BOTH PRESENT AND FUTURE.

UNDER THE CAPITALIZATION ARRANGEMENTS THAT EXISTED, THE COST OF SENDING TELEPHONE PERSONNEL TO A CUSTOMER'S HOME OR OFFICE TO INSTALL OR CHANGE THE CONNECTIONS FOR STATION APPARATUS WERE ADDED TO THE RATE BASE. SINCE THEY WERE CAPITALIZED, FUTURE CUSTOMERS CONTRIBUTE TO REPAYMENT OF THE COST, AND THROUGH COST ALLOCATION AND RATEMAKING METHODS, THE COST IS SPREAD THROUGHOUT THE ENTIRE NATIONWIDE TELEPHONE SYSTEM.

THIS LEADS TO ECONOMIC DISTORTIONS. MOST SIGNIFICANTLY, ALL RATEPAYERS ARE FORCED TO CONTRIBUTE REPEATEDLY TO THE RECOVERY OF ONE-TIME LABOR COSTS INCURRED AS A RESULT OF DECISIONS TO MOVE MADE BY INDIVIDUAL CUSTOMERS. THIS PLACED AN INEQUITABLE HARDSHIP ON MANY SUBSCRIBERS, PARTICULARLY ON ELDERLY AND OTHER LESS MOBILE CUSTOMERS. FURTHERMORE, CUSTOMERS WERE NOT AWARE OF THE ACTUAL COST OF CONNECTING THEIR PHONE OR THE BURDEN PLACED ON THE SYSTEM WHEN THEY MOVED OR REQUESTED CHANGES IN THEIR TELEPHONE EQUIPMENT.

CURRENT AND ANTICIPATED LOCAL TELEPHONE RATE INCREASES ARE, THEN, PRODUCTS OF INFLATION, THE TECHNOLOGICAL REVOLUTION RESHAPING TELECOMMUNICATIONS, COMPETITION, AND OF RESPONSIBLE, RESPONSIVE COMMISSION POLICY CHANGES. IN MAKING POLICY CHANGES, WE HAVE REPEATEDLY UNDERSCORED OUR CONCERN ABOUT LOCAL RATES AND HAVE IMPLEMENTED OUR POLICIES IN A MANNER DESIGNED TO AVOID MASSIVE DISRUPTION OR DRAMATIC RATE INCREASES.

THE PROPOSED CONSENT DECREE WILL NOT NECESSARILY PRODUCE ANY SUBSTANTIAL EFFECTS ON LOCAL RATES IF THE DIVESTITURE IS ACCOMPLISHED THROUGH A FAIR IMPLEMENTATION PLAN. OF COURSE, A REORGANIZATION PLAN WHICH IS NOT PROPERLY CONCEIVED COULD AFFECT THE DIVESTED BOCS IN A MANNER THAT INCREASES THEIR CAPITAL COSTS.

THIS EFFECT COULD BE REFLECTED BOTH IN LOCAL EXCHANGE RATES AND IN ACCESS CHARGES. THE FCC INTENDS TO REMAIN CLOSELY INVOLVED IN THE PROPOSED DIVESTITURE PROCESS TO ENSURE THAT THESE EVENTUALITIES DO NOT COME TO PASS.

ADDITIONALLY, LOSS OF YELLOW PAGES REVENUES COULD HAVE SOME DIRECT EFFECT ON LOCAL RATES. I AM NOT FULLY AWARE OF THE EXTENT OF THE PRESENT CONTRIBUTION, WHICH IS NOW A MATTER FALLING SOLELY WITHIN STATE JURISDICTION. I BELIEVE, HOWEVER, THAT A PORTION OF THIS REVENUE WILL CONTINUE TO BE AVAILABLE TO THE DIVESTED BOCS BY VIRTUE OF THEIR OWNERSHIP OF AN AUTOMATED DATA BASE CONTAINING ALL BUSINESS PHONE LISTINGS. AT&T WILL NOT HAVE AUTOMATIC ACCESS TO THIS DATA BASE AFTER DIVESTITURE. THE SALE OR LICENSING OF THIS DATA BASE, WHETHER ON AN EXCLUSIVE OR NON-EXCLUSIVE BASIS, SHOULD GENERATE REVENUES WHICH PARTIALLY OFFSET THE LOSS OF CURRENT YELLOW PAGE REVENUES.

THE MECHANISM OF THE PROPOSED CONSENT DECREE FOR COMPENSATING THE BOCS FOR THEIR PARTICIPATION IN INTERSTATE CALLING IS ONE OF ACCESS TARIFFS, RATHER THAN THE PRESENT AT&T/BELL OPERATING COMPANY DIVISION OF REVENUES CONTRACTUAL PROCEDURES. I DO NOT BELIEVE THAT SUCH A CHANGE OF THE MECHANISM, FROM ONE OF PRIVATE CONTRACT TO ONE OF TARIFF, WOULD NECESSARILY CHANGE CURRENT RESULTS. ACCESS CHARGES FOR INTERSTATE SERVICES UNDER EXISTING LAW WILL REFLECT THE EXCHANGE PLANT COSTS WHICH ARE ALLOCATED TO THE INTERSTATE JURISDICTION UNDER THE SEPARATIONS MANUAL. SUCH ALLOCATION IS WITHIN THE JURISDICTION OF THE COMMISSION UNDER THE COMMUNICATION ACT OF 1934. LOCAL EXCHANGE RATES WILL CONTINUE TO REFLECT THE REMAINING COSTS ALLOCATED TO THE INTRASTATE JURISDICTION.

TO SUM UP, CLAIMS THAT THE CONSENT DECREE OR THE FCC WILL "CAUSE" INCREASES IN LOCAL RATES ARE GROSS OVER-

SIMPLIFICATIONS AT BEST. IN FACT, THESE INCREASES ARE THE RESULT OF MULTIPLE FACTORS, ADDRESSED ABOVE. THE PROPOSED DECREE DOES, HOWEVER, SHARPEN OUR FOCUS ON CRITICAL POLICY ISSUES. AND, IT MAKES WATCHFULLNESS BY THE CONGRESS AND THE FCC IMPERATIVE TO ENSURE THAT A FAIR CAPITALIZATION PLAN IS PRESENTED.

I SHALL NOW ADDRESS THE OTHER SUBJECT OF THIS HEARING, WHETHER LEGISLATION TO AMEND THE COMMUNICATIONS ACT OF 1934 IS NEEDED. MY POSITION IS THAT A COMPREHENSIVE REVISION WOULD BE UNTIMELY UNTIL AFTER JUDGE GREENE HAS COMPLETED PROCEEDINGS UNDER THE TUNNEY ACT. BUT I DO THINK THAT IT WOULD BE PROFITABLE FOR CONGRESS TO CONSIDER "SHORT FORM" LEGISLATION AT THIS TIME.

IT IS VERY LIKELY THAT THE 1956 DECREE WILL BE SUPERSEDED IN THE NEAR FUTURE, EITHER BY THE TERMS OF THE AT&T/JUSTICE DEPARTMENT SETTLEMENT OR BY SOME VARIANT THEREON. THUS, LEGISLATIVE REVISION OF THE COMMON CARRIER PROVISIONS OF THE COMMUNICATIONS ACT NEED NO LONGER CONCENTRATE ON DIFFICULT ISSUES CONCERNING AT&T'S STRUCTURAL LINKS WITH ITS OPERATING COMPANIES. I BELIEVE THAT WE MOST PROFITABLY SHOULD ADDRESS TELECOMMUNICATIONS ISSUES ON THE ASSUMPTION THAT THE BOCS WILL BE DIVESTED, AND THAT AT&T WILL BE FREE TO COMPETE WITH OTHERS IN A BROAD RANGE OF NEW ACTIVITIES.

THE AGREEMENT BY AT&T TO DIVEST ITS LOCAL EXCHANGE COMPANIES IS A FAR-REACHING DECISION. IT MAY WELL RESOLVE SOME OF THE REGULATORY ISSUES WHICH LONG-FORM LEGISLATION IS DESIGNED TO ADDRESS, ALTHOUGH I RECOGNIZE THAT DIFFICULT PUBLIC POLICY QUESTIONS WITH RESPECT TO SEPARATIONS AND THE MECHANISM OF ACCESS CHARGES, WHICH EXISTED PRIOR TO THE ANTITRUST SETTLEMENT, HAVE NOT DISAPPEARED. IT IS MY VIEW, HOWEVER, THAT CONGRESS SHOULD TAKE THIS TIME, AS THE TUNNEY PROCEEDINGS UNFOLD, TO CAREFULLY ANALYZE THE CONSENT DECREE AND ITS POTENTIAL EFFECT ON THE SHAPE OF THE TELECOMMUNICATIONS INDUSTRY. AFTER

Judge Greene completes the Tunney Act proceedings, Congress will be in a better position to decide what comprehensive revisions of the Communications Act of 1934 are still needed.

I do believe that some changes to the 1934 Act could not only achieve broad-based support but also would largely ameliorate residual problems and new ambiguities which might be introduced by the decree. "Short form" legislation which I recommend would include the following provisions:

First, explicit authority should be granted the FCC to exempt carriers from the Title II provisions of the Act and to forebear from regulation. This would ameliorate uncertainties surrounding appellate review of the Commission's Computer II decision not to regulate "enhanced" services, and could clear the way for substantial deregulation of non-dominant carriers. I would propose that the FCC continue to exercise such authority through rulemaking, subject to comprehensive evaluation of specific deregulation proposals.

Second, a statutory presumption that the public interest favors competition, rather than regulated monopoly, should be stated. This would place the burden squarely on the proponents of continued regulation in any deregulation proceeding, or in licensing/certification proceedings involving additional entry in telecommunications. It would maximize opportunities for carriers to compete in the marketplace.

Third, clarification that the FCC retains authority over the separated BOCs to prescribe jurisdictional separations, accounting requirements and depreciation rates may be desirable. Such authority is inherent in the Commission's authority over interstate rates, and in Sections 201-205 of the Act to which "connecting carriers" are specifically subject. Nevertheless, legislative pronouncement would avoid the uncertainities

ASSOCIATED WITH POSSIBLE JUDICIAL APPEALS OF FUTURE REVISIONS TO THE SEPARATIONS MANUAL OR NECESSARY ACCOUNTING CHANGES BASED UPON JURISDICTIONAL GROUNDS.

FOURTH, CONGRESS SHOULD GRANT THE FCC JURISDICTION OVER ALL INTEREXCHANGE SERVICES, INCLUDING INTRASTATE TOLL HISTORICALLY SUBJECT TO STATE JURISDICTION. THE ARGUMENTS MADE IN FAVOR OF SUCH A TRANSFER IN EARLIER CONGRESSIONAL DEBATES APPLY WITH EVEN GREATER FORCE IN THE ENVIRONMENT OF THE DECREE, WITH ITS AT&T/BOC SPLIT GENERALLY FOUNDED UPON AN INTEREXCHANGE/EXCHANGE ACTIVITY SPLIT.

MY FOREMOST DUTY AS CHAIRMAN OF THE FCC IS TO PROTECT THE PUBLIC INTEREST. IT IS FROM THIS VANTAGE POINT THAT I, TOGETHER WITH THE ENTIRE COMMISSION, HAVE DIRECTED ANALYSIS OF THE PROPOSED CONSENT DECREE. ITS POTENTIAL REPERCUSSIONS IN THE DYNAMIC TELECOMMUNICATIONS INDUSTRY, AND IN RELATED ONES, ARE UNDOUBTEDLY MASSIVE. TO MOST SHARPLY APPRAISE THEM, I HAVE TRIED TO DISTINGUISH FACT FROM MISCONCEPTION. AND ONE FACT IS THAT NO ONE CAUSE, INCLUDING THE DECREE, WILL PRECIPITATE PROJECTED HIGHER LOCAL TELEPHONE RATES.

THANK YOU VERY MUCH.

Senator SPECTER. Welcome, Mr. Wunder.

Mr. WUNDER. Good morning, Mr. Chairman.

Senator SPECTER. We are pleased to have you here. Your statement in full will be made a part of the record. We would appreciate it if you would summarize, leaving the maximum amount of time for questions.

Mr. WUNDER. Certainly.

Senator SPECTER. Without objection, we will insert your prepared statement.

STATEMENT OF BERNARD J. WUNDER, JR., ASSISTANT SECRETARY FOR COMMUNICATIONS AND INFORMATION, U.S. DEPARTMENT OF COMMERCE

Mr. WUNDER. Mr. Chairman, I think I can summarize very quickly because my opening statement sounds a lot like Chairman Fowler's. Quite frankly, I agree with Chairman Fowler on the reasons why local rates are going to go up. Make no mistake about it, they are going to go up.

I would say additionally that we in the administration feel very strongly that the AT&T settlement is in the public interest.

As you know, I have worked extensively in the legislative arena prior to coming to the administration on telecommunications legislation. The issues that you are looking at today are ones that we have looked at for several years, especially the local rate question in an era of competition. It seems to me that was one of the driving forces and continues to be one of the driving forces for legislation in this Congress as in the previous two Congresses.

In terms of the administration, on your second question, we would support legislation in the area of access charges which would specifically address your local rate question issue. Other areas that we would support legislation in are forbearance from regulation, national defense and emergency provisions, and regulatory jurisdiction changes.

I would summarize, Mr. Chairman, by saying that local rates are going up as a result of essentially two reasons: Inflation and regulatory changes, with inflation being the largest single factor.

The regulatory changes that I would mention are the same ones that Chairman Fowler mentioned: Terminal equipment, expensing of inside wiring, changing the contributions by the capping of the subscriber plant factor, and accelerated depreciation.

We have done some studies on this local rate question, which we have provided to the committee. What our studies show is that the impact of the regulatory changes is going to occur over the next 5 years. What we see after the 1986 period is that those will essentially go away, and the rate increases in future years will be almost exclusively as a result of inflation. So, you will see upward pressure on rates for about a 5-year period and then not a leveling off but rate increases based primarily on inflation.

With that, Mr. Chairman, I would be glad to respond to any questions that you may have.

Senator SPECTER. Mr. Wunder, you testify that in your judgment the AT&T settlement is in the public interest. One of the subjects of inquiry when Assistant Attorney General Baxter was present was the extent that the Cabinet Council and the Department of Commerce played a role in those settlement negotiations in the context of the statute which imposes the sole obligation or the sole responsibility on settlement of the litigation on the Department of Justice. I give you that somewhat more extended background to show you direction of my concern.

To what extent did the Department of Commerce play any role in the settlement of the AT&T litigation, to your knowledge?

Mr. WUNDER. To my knowledge, and I think if anyone would have played a role and if anybody would have had knowledge, it would have been me, my answer to the question is that we played no role. We had a very clear distinction within the administration in terms of, we looked at the legislation in the Commerce Department because of our responsibilities under Executive Order 12046, as being the lead department in terms of telecommunications policy and telecommunications legislation, the question of settlement of litigation was, in our view and pursuant to the law, the exclusive province of the Antitrust Division in the Justice Department.

Senator SPECTER. Did you personally, or did anybody from the Department of Commerce, to your knowledge, confer with anybody from the Department of Justice about the terms of the settlement?

Mr. WUNDER. No, sir.

Senator SPECTER. Who from the Department of Commerce sits on the Cabinet Council?

Mr. WUNDER. Secretary Baldrige.

Senator SPECTER. Did you participate in any of the proceedings with respect to the Cabinet Council?

Mr. WUNDER. Yes, sir.

Senator SPECTER. Without prying into matters which are in the ambit of executive privilege, how did that function?

Mr. WUNDER. It functioned with respect to the legislation primarily. What we were asked to do—and Secretary Baldrige has testified on this already, so I do not think that there is any executive privilege issue; if there was, it has been waived as a result. What we were asked to look at was impediments to legislation. The administration very much wanted to update the 1934 act. It is an act that has not been significantly amended since 1934.

For instance, a case in point that makes the point very easily is that television is not even mentioned in the 1934 act, neither is cable. The situation that existed in terms of the technology in 1934 is nowhere comparable to what we have today. The 1934 act contemplated a monopoly which existed at the time with the introduction of competition and the types of issues that you have been discussing here today, quite frankly, what in the competitive era happens to the local ratepayer, how do you provide a competitive environment on the one hand and without significant impact on local rates on the other, and how do you move in a gradual sense to that point.

What we did was looked at that. Clearly, one of the impediments that we found to the passage of comprehensive telecommunications legislation was the *AT&T* antitrust case. The experience in the House—and I was a direct participant in those proceedings in the last Congress—made it clear to me and others in the administration that the case was clearly an impediment. We had a task force within the executive branch that looked at the question and said: Yes, this is one of the impediments to the passage of legislation.

Senator SPECTER. Well, if that is an impediment, was not there some discussion about ways of getting rid of the impediment, like a settlement?

Mr. WUNDER. Not settlement. What we recommended was dismissal.

Senator SPECTER. Was there discussion of dismissal?

Mr. WUNDER. Yes, sir.

Senator SPECTER. What did that discussion consist of? Did the Department of Commerce want the case dismissed?

Mr. WUNDER. Yes, sir.

Senator SPECTER. Is not that impinging on the sole responsibility of the Department of Justice?

Mr. WUNDER. No, sir, we were simply making a recommendation. There were discussions of it at the cabinet council. Attorney General Baxter was a full participant. He suggested that that was not the course to take, and that was the position that prevailed.

Senator SPECTER. Ultimately he went to court and asked for an 11½-month delay in the case pending the outcome of the legislative process.

Mr. WUNDER. Let me explain this, Senator Specter.

Senator SPECTER. On that subject, did not the discussions in the Cabinet Council have a direct effect on Mr. Baxter's position as to the recommendation to delay?

Mr. WUNDER. The discussions that we had in the Cabinet Council and following the Cabinet Council on sort of a working group basis, in which Assistant Attorney General Baxter was involved, were in the questions of how long it would take to resolve the *AT&T* case. There was a very significant need in everyone's mind—and, I think, including Assistant Attorney General Baxter—that something had to be done to deal with these telecommunications issues.

When we looked at it, at the time there were no prospects of settlement. I think that was the furthest thing from anyone's mind, that there could be a mutually agreeable settlement where Justice and AT&T could get together. We looked at it from the standpoint of how long it would take to complete the case and then the subsequent appeals. In all of that time, there would be total uncertainty in the marketplace and in the telecommunications industry as a result of failure to accomplish things that could be done legislatively.

Mr. Baxter's position was I have certain goals that I am seeking to achieve. If I can find an acceptable proxy, if I can do something legislatively that achieves the same ends as I would have achieved if I had brought my case to term and won a judgment against AT&T, that would be acceptable to me because what I am interested in is competition. What I am interested in is competitive environment. What I am interested in is nondiscriminatory treatment by Bell operating companies.

What he said was, if legislation could be done right, it would achieve the goal. So, what we did was attempt to work out some legislation and some amendments which were then later sent to the Hill and which Senator Thurmond introduced as a part of 898 that would be——

Senator **Specter**. Mr. Wunder, I am reluctant to interrupt you here, but we have so many witnesses. Let me draw my line of inquiry to a close at this point before turning to Senator Leahy.

Are you making a distinction between settlement of a case and dismissal of a case so that you say that the Department of Commerce has a lawful role to play in dismissal but not in settlement?

Mr. **Wunder**. I think we have a lawful role to play. All we did was, what we did was identify that as an impediment and recommended that there be dismissal. That was the judgment, our judgment and Department of Agriculture's judgment and Department of Defense, FEMA, and Department of Energy. The way the Cabinet Council worked——

Senator **Specter**. Everybody agreed except the Department of Justice?

Mr. **Wunder**. Everybody agreed except the Department of Justice, yes.

Senator **Specter**. Senator Leahy?

Senator **Leahy**. We had talked about what led up to this, and maybe we can talk just a wee bit of where we go now. Do you see any barriers to the concept of the BOC's engaging in some competitive activities with an antitrust point of view, or do you think that there is a practical chance that the problems of cross-subsidization can be avoided?

Mr. **Wunder**. Senator Leahy, right now today and until competition develops in the local exchange market, which it will—it is coming now with DTS service and certain types of cable service. You see Manhattan Cable offering data processing. But until that time comes and that comes to fruition, Bell operating companies engaging in those types of competitive undertakings would pose significant cross-subsidy problems. That is why the consent decree is written as it is and uses the containment theory to hold them in check until such time as the marketplace does change and the consent decree makes provisions where the BOC's can get modifications of the decree when those changed circumstances occur. There is essentially the same sort of containment theory that was used in the 1956 consent decree.

Senator **Leahy**. A lot of us are concerned about how you handle this with evenhandedness, especially those of us who have to look at rural areas, as I do. Throughout all of this the warning bell that keeps going off in my mind is what happens out in those rural areas? One of the larger small towns in our State has about 1,100 people in it. I could also, as you could, too, go down through communities, whether it is in West Virginia, Vermont, Pennsylvania, or anywhere else with the small ones. I think I will probably be submitting some further questions to you on the rural ones.

Let me ask another question. If we have this consent decree and we will all be looking at it, but there is going to be a temptation, in fact many of us say a need, to start proposing some legislation of our own. Suppose we propose legislation to divest the BOC's intact and then to have an asset transfer. How would you feel about that?

Mr. **Wunder**. Have the divestiture occur first is the question?

Senator **Leahy**. And then to have an asset transfer.

Mr. **Wunder**. I have some——

Senator **Leahy**. With the BOC's intact.

Mr. **Wunder**. I understand.

It is the question of giving the BOC's a voice in the valuation of the assets. In terms of the divestiture that is contemplated by the proposed decree, the division of the assets is really the key role that is being played by the Justice Department. I think that is a decision that continues—there is a continuous need to have Justice Department supervision of that because it plays such a critical role in whether or not we produce the kind of environment and the kind of competitive environment that is contemplated by the decree.

In terms of the valuation, the valuation question was mentioned earlier by Commissioner Fogarty. That is going to be a function that is going to be performed by the regulatory agencies with respect to the BOC equipment by State regulators and for the interstate equipment by the Federal regulators, with the only other role being performed by the Justice Department, determination of which debt goes to which of the two entities. Justice has indicated that they were going to play a fairly significant role in that in their competitive impact statement to see that that is fairly apportioned.

I would think that there would not be a necessity to do that. I think that it would probably cause considerable delay. What this industry needs more than anything right now, Senator Leahy, is certainty. I think we need to get on with the work that the Justice Department begin.

Senator **Leahy**. What about keeping the Yellow Pages in the BOC's?

Mr. **Wunder**. We have done some rate studies. As I indicated, I submitted that to the committee. What our figures show is that the keeping of yellow pages in the BOC's would really not have significant impact, one, on rates, a difference of about 1.2 percent per year. Second, what the BOC's are going to have is the most valuable part of the whole yellow pages process, and that is the numbers, the machine readable listings which they are going to be able to auction off.

I think that the split that needs to occur and something that it seemed to me before the settlement that there was reasonable consensus on both in the House and the Senate was that what you were trying to do was split competitive activities that were not natural monopolies from noncompetitive activities which were natural monopolies.

Senator **Specter**. Without objection, a statement from Senator Baucus will be placed in the record.

[Prepared statements follow:]

Statement of

Bernard J. Wunder, Jr.
Assistant Secretary for Communications and Information
U.S. Department of Commerce

Thank you for this chance to express the Administration's general views on the proposed settlement of the Justice Department's antitrust case against AT&T.

We support this proposed settlement, Mr. Chairman, because we believe that it will yield significant long-term benefits to the American people. From our unique perspective at the Department of Commerce, perhaps the single most important aspect of the proposed settlement is the elimination of the restrictions imposed on AT&T and Western Electric under the 1956 *Western Electric* consent decree. Telecommunications and computer-data processing technologies are now and have been converging. Users increasingly regard communications and computer services as functional alternatives. Yet under this antiquated consent decree, two of the leading firms in the telecommunications field were essentially prevented from offering the public many of the new, more modern, and advanced services.

The public policy underpinning the 1956 consent decree constituted basically a containment theory. The assumption was that as long as the Bell System enjoyed an extensive, regulated monopoly base, its commercial activities should be artificially constrained, in order to prevent it from using the leverage conferred by that monopoly base to gain unfair competitive advantages.

Under the proposed settlement, AT&T and Western Electric will no longer own and control local telephone exchange operations. This franchised monopoly base having been divested, these two firms will be allowed to broaden the range of new and competitive services and products that they offer to customers both here and abroad. The Administration accords great importance to this proposed relaxation of outmoded constraints on two of our most competent communications industry competitors. The level and intensity of competition -- and particularly foreign-based competition -- in both the domestic and world markets for telecommunications products is rapidly increasing. Testifying before the House Telecommunications Subcommittee recently, for example, an AT&T witness noted that its competitors are now capturing about 50 percent of the new Private Branch Exchange (PBX) market, and half of the wins are going to foreign multinationals. In the case of key telephone systems, Western Electric's competitors are winning 70 percent of the time, and, again, half of their losses are to foreign competitors. */ These constitute among the fastest growing and most profitable lines of the communications business, and I do not believe that we can afford to relinquish them to foreign-based competitors needlessly.

Overseas, moreover, American companies such as AT&T and Western Electric currently confront an array of very large, diversified competitors in the telecommunications and related data processing fields. These firms include very large, multinational conglomerates such as (1) West Germany's Siemens combine -- which is only slightly smaller than Western Electric and Westinghouse, combined; (2) Philips, which is headquartered in the Netherlands, produces an array of electronic and communications products, and which is slightly larger than Siemens; (3) Hitachi, which is one of Japan's largest manufacturers; and (4) Mitsubishi Electric, which is affiliated with one of the world's largest industrial enterprises. */ Each of these very potent competitors is currently devoting substantial attention to developing new, computer-based, communications offerings. Each of these firms, moreover, currently enjoys considerable support from its home government. It is no secret that several European nations and Japan have specifically targeted telecommunications as one of the key areas for future economic development. These firms are actively seeking a firm position in the U.S. domestic market, in order to facilitate their commercial success in other countries.

The proposed settlement should improve our overall competitive and trade posture in the telecommunications and information services sectors, both domestically and overseas. This is of critical national economic importance, given the pivotal role these industries play, and will play, in facilitating the smooth, efficient, and competitive performance

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*/ Statement of Mr. Charles Marshall, Executive Vice President, AT&T, Before the House Telecommunications Subcommittee, 97th Cong., 2d Sess., at p. 11 (February 23, 1982).

*/ See Appendix A (Leading International Telecommunications and Data Processing Firms)

of our complex free enterprise economy. We do not believe, moreover, that the divestiture that the settlement will entail necessarily has to have any significant adverse impact on the continued availability of universal telephone services, as some have alleged.

The Reagan Administration has adopted positions on common carrier communications legislation desirable in four areas: (1) access charges and rate stability issues; (2) national defense, security, and emergency preparedness; (3) certain jurisdictional questions, involving the appropriate apportionment of State and Federal regulatory authorities; and (4) mandating deregulation of effectively competitive offerings.

With respect to local rate issues, we believe that the FCC and the States have sufficient authorities to properly allocate the costs of telephone service between local and long-distance service customers. If Congress is concerned, however, that State and Federal regulators will not take the necessary steps to ensure that local phone rates do not increase unreasonably, it can mandate an access charges mechanism to deal with the issue. We are fully prepared to work affirmatively with Congress in this regard.

Our private telecommunications industry also serves a vital role in safeguarding national defense, security, and emergency preparedness. As Defense Department witnesses have indicated, for example, over 90 percent of the communications circuits they rely on domestically are provided by private companies. The proposed decree contains provisions designed to facilitate industry actions in aid of the national defense and emergency preparedness. It is thus appropriate for the 1934 Communications Act to be amended now in recognition of the importance of this industry to national security and emergency preparedness, and to ensure that the Federal Communications Commission (FCC) accords the proper weight to these critical interests.

The present jurisdictional split between Federally regulated interstate and State regulated intrastate long-distance service is another "non-structural" area that we believe warrants prompt Congressional attention. The current regulatory distinctions are not based on technology, and they too often require telecommunications firms to file and to maintain duplicative tariffs and other materials for the same service. These traditional distinctions do not facilitate competition and efficiency in intercity, long-distance communications markets, and we believe that they thus should be changed along the lines of S. 898.

Finally, there is the question of the FCC's authority under current law to deregulate even effectively competitive telecommunications services. */ The Administration believes strongly that services and offerings, including telecommunications services, should not be subject to pervasive economic regulation when there is effective competition, or reasonably interchangeable service alternatives.

The proposed settlement, of course, does not deregulate any service. It is important that the FCC be accorded this explicit deregulatory authority now, as the industry becomes more and more competitive. Experience in this, as well as other regulated industries, teaches that as competition grows, so too does the probability that firms will seek out a regulatory shelter from what they perceive to be "cut-throat" or "excessive" competition.

We believe that Congress should act now to forestall the possible increase or continuation of unnecessary economic regulation. In order to achieve this desirable goal in the most timely and efficient fashion, new legislation is needed.

While the Reagan Administration thus could support enactment of focussed legislation in these four important areas, we would strongly oppose legislation incompatible with the terms of the proposed settlement. The Administration would oppose, for example, legislation seeking further to restructure AT&T, or placing artificial constraints on the services that the firm might offer.

In conjunction with the Commerce Committee's consideration of S. 898 last year, a number of amendments to that bill were developed by this Committee's expert antitrust staff, and were incorporated into that measure with the Administration's full support. Included were amendments dealing with such matters as Bell System procurement from unaffiliated suppliers, license contracts, and certain records-keeping obligations. Virtually all of these proposed safeguards against potential anticompetitive conduct and practices, however, were premised on the continued common ownership and control by AT&T and Western

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*/ See, e.g., AT&T v. FCC, 572 F.2d 17 (2d Cir. 1978).

Electric of so-called "bottleneck" facilities, namely, the local exchange operations of the present Bell System operating companies.

Under the proposed settlement, this substantial monopoly base will no longer be owned and controlled by these firms. AT&T and Western Electric, in short, will no longer enjoy the potential leverage with respect to actual and potential competitors that they currently enjoy. This being the case, we do not believe that special legislation aimed at these two firms is appropriate.

There is no good reason, in our judgment, to assume that the generally applicable antitrust laws will prove insufficient to ensure full and fair competition in the telecommunications field. It is true that AT&T and Western Electric will continue under common ownership and control. But it is also true that virtually every line of commerce relevant here is becoming increasingly competitive. So-called "deep-pocketing" or predatory pricing is not a feasible commercial practice over time, when all of the markets that a firm functions in are either actually or potentially competitive. Such practices are also among the clearest of antitrust violations, and thus subject to severe Government and private treble damage action sanctions. I believe that dollar awards of the magnitude we have seen recently in some private antitrust cases do give rise to a very substantial deterrent effect. The proposed decree also calls for a continuing role on the part of the court, and accords the Department of Justice extensive visitorial powers, in addition to those that it enjoys under recently enacted antitrust procedures legislation. Moreover, as the Justice Department has aptly observed, many of the firms with which AT&T will be competing in both traditional telephone and evolving telecommunications-data processing markets, "are no industrial pygmies." */ Among these actual and potential competitors -- and their Forbes 500 rankings -- are American Express (86th), which is in partnership with MCI; ITT (12th); GTE (28th); United Technologies (35th), a major wire and cable supplier; IBM (10th); General Dynamics (109th), which owns both Strömberg-Carlson. And, of course, the diversity of well-heeled foreign multinationals, and their domestic U.S. subsidiaries (e.g., Mitel, Northern Telecom) that

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*/ See Comments of the U.S. Department of Justice in FCC Docket No. 20828 ("Second Computer Inquiry"), at p. 43 (filed May 26, 1977).

I discussed. The Administration, in short, does not believe that communications legislation going beyond the scope of the four important, key areas that I discussed earlier is appropriate or needed, and especially not at this time when the terms and conditions of the proposed settlement are being carefully considered by the antitrust court.

It may be that at some future time, after the dust settles, Congress will want to review progress achieved under the proposed settlement, and wish to assess its successfulness in fostering greater competition and efficiency in these important, growing markets. We very strongly believe, however, that the most prudent course of action at this time with regard to structural issues is to permit the settlement process to go forward unimpeded.

We would thus strongly caution against any legislative efforts to shoot at some nominally anticompetitive "moving target," which may never materialize in fact once the final terms of the settlement are worked out. We believe, moreover, that Congress might most appropriately want to wait some time after the settlement goes into effect before seeking to enact further legislation. Virtually all of the competitive safeguards that were incorporated in S. 898, after all, were premised not upon hypothetical, but rather "real world" problems, difficulties that had been demonstrated by several years of actual experience. The proposed settlement of the AT&T antitrust case, however, makes such sweeping and fundamental alterations in the structure of our telecommunications industry as to render much of that past experience obsolete.

In conclusion, the Administration believes that Congress should now limit its legislative activities regarding domestic telecommunications to four areas: (1) access charges and rate stability issues; (2) national defense and emergency preparedness concerns; (3) jurisdictional changes and reforms; and (4) regulatory forbearance and mandated deregulation of effectively competitive services.

Other than these four areas, we think that the most prudent course of action for Congress at this time regarding structural issues is to wait until the decree is entered and, perhaps, to wait further until we have some experience with it under our belt. We believe that many of the previous structural and competitive problems that were perceived will be resolved by the settlement. Congress, in any event, should permit the settlement process to go forward unimpeded, and legislation incompatible with its terms and conditions should not be acted upon favorably while this matter is before the antitrust court.

FIGURE 1: Top Foreign Data Processing Contenders.

Rank	Company	Country	DP Revenues	Total Revenues	Employees
1	Hitachi, Ltd.	Japan	$1,830 M	$10,804 M	138,690
2	Toshiba	Japan	1,633	7,847	113,800
3	Fujitsu Ltd.	Japan	1,248	1,761	32,062
4	CII-Honeywell-Bull	France	1,061	1,061	NA
5	ICL	Great Britain	1,019	1,019	33,978
6	Olivetti	Italy	789	1,879	66,073
7	Siemens AG	Germany	703	15,675	322,000
8	Nippon Electric	Japan	672	3,249	60,554
9	Philips NV	Netherlands	602	14,000	400,000
10	Nixdorf AG	Germany	554	554	9,200
11	Oki Electric	Japan	200	575	14,200
12	Mitsubishi Electric	Japan	190	3,960	NA

Source: Datamation, May 25, 1979 at p. 79.

FIGURE 2: Major International Telecommunications Equipment Manufacturers.

Rank	Company	Country	Telecom Sales (77)	Total Sales
1	Western Electric	U.S.	$8,140 M	$ 8,140 M
2	ITT	U.S.	3,770	16,690
3	Siemens AG	Germany	2,090	10,850
4	Ericsson	Sweden	1,670	1,670
5	GTE	U.S.	1,540	3,560
6	Northern Telecom	Canada	1,270	1,270
7	Nippon Electric	Japan	900	2,270
8	Philips NV	Netherlands	850	12,700
9	CGE	France	720	6,665
10	Thomson CSF	France	700	4,010
11	GEC	Great Britain	620	3,590
12	Plessey	Great Britain	450	990

Source: Telephony, October 22, 1979 at p. 116

STATEMENT OF SENATOR MAX BAUCUS
IMPACT OF AT&T DIVESTITURE ON LOCAL RATES
MARCH 25, 1982

The recent antitrust settlement between the Department of Justice and AT&T should not be quickly dismissed as a victory for free economic competition. The proposed settlement leaves many questions unanswered. It is through hearings such as this one today that concerned members of Congress can begin to study what the settlement will really mean to the American consumer.

I am most concerned about what this settlement will do to the local service charge on our phone bills each month. There are some predictions that local rates will triple.

Already local companies have started filing for rate increases. Mountain Bell in Montana recently requested a rate increase that would nearly double basic service rates for home and business phones. And Montana Bell claims that these rate increase requests are not related to the AT&T settlement, but are merely tied to inflation.

Just recently I met with one of Montana's public utilities commissioners to discuss the implications of the settlement on the citizens of Montana. It was his assessment that the settlement could lead to a 300 percent increase in the local service charge. This coupled with the most recent increases could mean a 400 percent increase in phone rates in a two-year period.

While the public would be gouged by these outrageous rate hikes, under the proposed AT&T settlement, AT&T would get to keep its profitable long lines department. It would keep Western Electric. It would keep Bell Labs. And it would keep a new, unregulated high-tech subsidiary that can provide sophisticated business services, data processing and any future technology developed there.

In exchange, Bell gives up its twenty-two local phone companies, which are the most capital intensive and least profitable part of its business. But under the consent decree, AT&T carries off a good deal of the capital, and hence the rate base. All the phones, all the customer switchboards and any local phone company hardware that can be claimed as long distance equipment will revert to AT&T.

The local operating companies, like Mountain Bell, will have to demand higher rate of return to keep up their revenue. They will enjoy less of a capital subsidy from the bell system. And they will be shut out from profitable sidelines. Their only product will be a dial tone. The likely result is that there will be more expensive, less technically up-to-date phone service for the average customer.

I plan to keep a close eye on this situation. I believe telephone service should not become a luxury for the rich. We have an obligation to the public to make sure that telephone service which is a lifeline for so many, does not become a hangman's cord--choking the American public with unreasonably high rates.

I think a 300 or 400 percent increase is unconscionable. If that is where this settlement is leading us, it represents totally unacceptable government conduct. I for one will not remain silent while the Department of Justice negotiates away the hard-earned dollars of every American consumer.

Hopefully, hearings such as this one today will begin the necessary dialogue to sort out the answers to the questions raised by the AT&T divestiture. I hope these hearings will lead to a greater public awareness of the real implications of the AT&T settlement.

THANK YOU.

Senator SPECTER. Thank you very much, Mr. Wunder. We very much appreciate your coming.

Next we will hear a panel consisting of the Honorable Louise McCarren, chairman, Public Service Board, Vermont; the Honorable Susan Shanaman, chairman, Pennsylvania Public Utility Commission; and the Honorable Edward Burke, president, National Association of Regulatory Utility Commissioners, Providence, R.I.

Welcome, ladies and gentlemen. We appreciate your being here today. We have received your written testimony. It shall be made a part of the full record. We would like to proceed at this time, if we may, to having you summarize, leaving the maximum amount of time for questions. Let us start with you, Chairman Shanaman, if we may.

STATEMENTS OF A PANEL CONSISTING OF HON. SUSAN M. SHANAMAN, CHAIRMAN, PENNSYLVANIA PUBLIC UTILITY COMMISSION; HON. LOUISE McCARREN, CHAIRMAN OF THE VERMONT PUBLIC SERVICE BOARD; AND HON. EDWARD F. BURKE, PRESIDENT, NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS, RHODE ISLAND

Ms. SHANAMAN. Thank you, Mr. Chairman.

Sitting here and listening today to the impact or the possible impact of the divestiture and some of the FCC policies, we hear the nominal sum or what sounds like a nominal sum of $5 being bandied about and saying that, certainly, if we have an increase of that nature, that is not much; it does not sound like much in today's world. Part of that $5 might consist of $1.05 for loss of Yellow Pages revenues to the local companies and the local ratepayers. Again, that does not sound like much.

I would like to give you a real experience that has occurred in your home State, in the center of the State, in Indiana County. That was our State PUC had, if you want to call it, the misfortune of entering a rate order approximately a year ago which increased service approximately $5 a month to those customers, a 15-percent increase. As a result of that, within about 3 months after that order, nearly a third of the customers either disconnected or substantially reduced the level of service that they received.

Senator SPECTER. Are you saying that a $5 increase was a 15-percent increase?

Ms. SHANAMAN. They are the highest in the State. It was going from approximately $17 a month to $21 a month. That is high, and it is high for the State of Pennsylvania. But in terms of when we are looking at is there an elasticity that a $5 or a 15-percent increase can cause, I would suggest to you that, yes, there is an elasticity.

Senator METZENBAUM. I did not quite follow. You said it went up from $17 and went up $5?

Ms. SHANAMAN. No; it went from $17—I used the $5 figure—up to the $21, a little bit over $21, $21 to $25. That is not quite $5 dollars, I recognize that. But it was a 15-percent increase to those customers.

Senator METZENBAUM. But that is more than 15 percent; 15 percent of $17 is $2.55.

Ms. SHANAMAN. I will trust your calculations. When I originally calculated it, I came up with 15 percent.

Senator METZENBAUM. It is substantially more than that. It is 4¼, you said, as compared to 17. It is exactly a 25-percent increase.

Senator SPECTER. But it is less than a doubling.

Senator METZENBAUM. Less than a doubling, that it is.

Ms. SHANAMAN. I hope I do not lose my point in my miscalculation of the percentage. That is, when you are talking about that kind of dollars, yes, it does have an impact. There is a price elasticity.

Senator METZENBAUM. Go right ahead.

Ms. SHANAMAN. Competition is certainly here. Competition can be beneficial. I do not think any of the State regulators are looking for a denial of the marvels of competition and what effect it can have on the telecommunications industry. We are concerned, though, with moderating perhaps its immediate impact upon the customers in terms of going to a 200- or a 300-percent increase.

We feel that that impact can be moderated if, in fact, the BOC's are divested intact, if you have State jurisdiction over access charges and intrastate toll. I think we have a list of approximately eight points which we feel can moderate the impact.

We feel very strongly that the States should remain involved in that. Why? Because we are closer to the local conditions. When you have 1,500 telephone companies with over 17,000 exchanges, we seriously doubt that the FCC is capable of handling those kinds of decisions and setting access charges on an individual basis that reflects local conditions, local costs as opposed to some sort of nationwide average.

We feel very strongly that those kinds of issues should remain within our jurisdiction for another reason. That is that over half the customers within Pennsylvania do not make a toll call during any given month. So, to the extent that the competition which we are going to see in the toll market is going to be beneficial, I have a feeling those people are not going to see that beneficial competition by the fact that the toll rates do not increase or remain stable or, in fact, maybe decrease. So, there is another area and another reason why we as States feel that it is extremely important that we maintain the jurisdiction in these matters.

I believe that it is important and up to Congress at this time to take a look at these issues and to, in fact, fashion legislation which will continue very needed protections for the local ratepayers that have become obvious as a result of this AT&T divestiture.

Senator SPECTER. Thank you very much, Chairman Shanaman. Without objection, your prepared statement will be inserted into the record.

We now turn to Chairman McCarren of Vermont. We will do the questioning of the panel as a group.

Ms. MCCARREN. Thank you, Senator. I would echo what Chairman Shanaman said. It seems to me that the goal we are all trying to achieve is to usher in the competitive age and to achieve deregulation over a period of time. From Vermont's perspective, we need to usher in that competitive environment to insure that all of the new technology is brought to Vermont on a timely basis. We also have to insure that local service remains universal and affordable in order to maintain the social and cultural fabric on a very rural and very poor State.

The issue that I see as most important is the condition in which the BOC's are going to be left after the divestiture. It is my view that the consent decree will over the long run result in their demise.

Senator SPECTER. The demise of what?

Ms. McCARREN. The Bell operating companies as we know them today. And that is because they are not allowed to compete, and they are allowed only to offer monopoly services and exchange services. I think that this, over the long run, will result in their demise and will be counterproductive to the two goals of competition and universal service. I think that what we will see is operating companies who are tied, they cannot compete, they cannot offer the new services. That will in rural States, I believe, hamper the introduction of competitive services. At the same time, the consent decree will cut off all of their revenue streams or many of their revenue streams and make it almost impossible for them to continue to provide affordable basic exchange service. I see that as the fundamental flaw in the divestiture.

We can then go on and talk about ways to ameliorate that problem. I agree with Chairman Shanaman that the operating companies should be spun off intact. That would be one ameliorating factor.

I also agree that the access charge has to be set by the local regulators. I think you will hear from many people that that should not be because State regulators are prone to listening to petty local politics in setting the basic exchange rate. What they will have to do is set that basic exchange rate low. They will then have to set the access charge too high. This will be destructive to competition.

I would point out to you that a State regulator cannot set an access charge that exceeds the bypass cost. That is an inherent protection.

I would argue to you that, if the FCC is allowed to set the access charge, that they will set one universal charge for the country. It will be very low. What will happen is in rural States particularly a great deal of revenue will have to be made up from local exchange or intrastate tolls. Just to give you a number, in Vermont the separations relating just to interstate tolls amount to $5.84 per month per telephone. That alone is $13.5 million a year for a State the size of Vermont, which has 200,000 main stations. That amount alone will have to be made up from the access charge or some other place. That other place, of course, is basic rates.

I disagree very strongly with what Chairman Fowler told you. He cited the deregulation of CPE as causing a massive increase. The figures that I have show that for Vermont the effect of that is 63 cents per month per main station. Now, you compare that to the $5.84 that I gave you, and you can see there is a substantial difference.

I would just urge you to very seriously consider the condition in which the BOC's are going to be left. I think it is crucial that they be left in a position where they can compete and offer competitive services.

I disagree with Mr. Wunder. The problem of cross-subsidization has been with us and will be with us. The cure for that is not to prohibit the BOC's from competing. The cure is to set up effective accounting regulation within the States. Thank you.

Senator METZENBAUM. Before you conclude your testimony, would you care to comment on whether or not you think that divestiture in the manner in which it is presently structured serves the public interest?

Ms. McCARREN. I strongly do not think that it does. I think that the goals, that is increased competition and decreased regulation, we must go there. We must do it. But the way that it is done now, it is done at the expense of the BOC's, and I think that is a mistake.

Senator METZENBAUM. Would you care to answer the same question?

Ms. SHANAMAN. I agree. I do not think the current mode is in the public interest. What you have is essentially one party negotiating on behalf of both sides. You have the local BOC's, what is left, who are still under AT&T. So, who is negotiating on both sides? AT&T.

The suggestion was made that the Department of Justice can monitor this and make sure that this division occurs appropriately, I am sure they can; but they are going to be monitoring it in terms of antitrust, not in terms of what is left to regulate and what that local ratepayer impact is going to be.

Senator METZENBAUM. Mr. Chairman, I would like to urge upon you that some serious consideration be given to this committee expressing itself on the whole question of the public interest and whether the public interest is being served in the divestiture agreement. I have felt that in the past divestiture made sense, that free competition ought to be permitted to operate. But, as I see it, here are chairpersons of two commissions in the country; they do not think the public interest is being served. I do not know the next gentleman, what his response will be; I would be interested. But I have the feeling that the Senate has some obligation to express itself on this subject. I would like to urge upon you that you consider, if you agree with this Senator on that point, that perhaps we as a group make some effort to state our views publicly.

Senator SPECTER. The distinguished Senator from Ohio has as usual made a very cogent suggestion to the chairman. One practical problem is that the chairman's status is of very limited duration.

It is a subject which I think our committee should consider. I will transmit the suggestion to the permanent chairman and see if I could have it added to the agenda so that the full committee may take it up.

Senator METZENBAUM. Thank you, Mr. Chairman.

Senator SPECTER. Mr. Burke, it is your turn. Without objection, we will insert Chairman McCarren's prepared statement.

Mr. BURKE. Thank you, Senator. My name is Edward F. Burke. I am the chairman of the Rhode Island Public Utilities Commission. I am the national president of NARUC, the National Association of Regulatory Utility Commissioners. Paul Rodgers, our executive director, is also here.

I am in the middle here. I have to stay somewhat in the middle because we are representing 50 States and the 4 Federal territories. So, there is this question relative to divestiture that was asked by Senator Metzenbaum and whether it is in the public interest.

Let me just give you quickly the process that we have gone through to show the seriousness with which the entire matter has been taken by the State commissioners. Right after the announcement was made by the Justice Department on what they were going to do, we decided we could not operate on a business-as-usual basis this year. I called a meeting in Washington of the States on the 1st of February. I am pleased to say that 39 States appeared. Staff members came from all over the country. We had over 100 in attendance. We had 2 days in which we cross-examined Mr. Baxter and a vice president of AT&T and staff counsel of the Senate and House committees. So, we had a very extensive session.

We went from that session to a very important meeting later in February where we had several hours with Mr. Charles Brown. We examined him very extensively. Then I think a remarkable thing happened. Here we are, 50 States; we have an executive committee. We come from all areas of the country. We adopted nine points by overwhelming votes.

Certainly, I have to credit the Justice Department and AT&T. They have everybody's attention. There has been a lot of talking and a lot of circular action for some years.

Senator **Specter**. Did you express yourself on the question which Senator Metzenbaum has raised about your view as to the divestiture issue?

Mr. **Burke**. Yes; we felt that the public interest—I think collectively that we did not take a position that we felt divestiture was not in the public interest. I have to say that. We felt that we were concerned with the process that we wanted to have a full opportunity to comment. Our first and our fundamental concern which we expressed was that we were alarmed by the proposals within the divestiture agreement by which the assets would be spun off, determinations would be made as to where personnel would be located by a plan that would be prepared by AT&T and ultimately, supposedly, approved by the Justice Department but which would be involved in a process in which all of the parties within the company in the BOC's and in the parent organization would be under the same tent until after divestiture.

This was a matter of great concern. That is why we have called for some form of spinoff or divestiture in the first instance before those determinations are made.

I served 27 years in the U.S. Air Force and reserve as a JAG officer. I learned about the principles of military justice. One of the fundamental principles was to make sure that there was not command control of military justice decisions. We feel very strongly that the circumstances of this situation run a parallel course. For 2 or 3 days after the announcement of divestiture there were some Bell operating company executives who were quoted in the press as anticipating doubling or trebling of local rates based on divestiture alone. I heard Chairman Fowler, and there is no question. There are other pressures for the increase of local rates.

By the beginning of the week, statements were issued all across the country that there would be no impact whatsoever on local rates because of divestiture.

Senator **Specter**. What is your thought on that? What is your judgment as to what the effect will be on local rates attributable solely to divestiture?

Mr. **Burke**. Sir, I think that this is one of the problems. I do not think anybody can give a final answer on that at this point. The problem of allocating costs has been a continuing one. You heard the attempts of the FCC to answer your questions this morning. One of my concerns is that within the process and before Judge Greene there should be some analysis of this. After all, this decision is going to affect us for a generation to come. The consent decree of 1956 affected us for 25 years.

Senator **Metzenbaum**. Don't you have an opinion? The chairman asked you if you have an opinion.

Mr. **Burke**. My opinion is that there is going to be an upward thrust. I have heard no one who said that it is going to do less than double the rates, and it could treble the rates over 5 years.

Senator **Metzenbaum**. What is your opinion as to whether or not the divestiture as presently contemplated is in the public interest?

Mr. **Burke**. The divestiture as presently contemplated, Senator—and I am sorry I cannot give a yes or no answer on that because part of it is what the Tunney Act comments—NARUC strongly supported having Tunney Act public comments before Judge Greene. We have got the highest respect for Judge Greene. We think that possibly with some modifications divestiture can be in the public interest.

Those modifications include arm's-length negotiation on the division of assets between AT&T and Bell.

Senator **Metzenbaum**. But you know that that is not going to happen.

Mr. **Burke**. I do not know that that is not going to happen at this point. I said that it is before Judge Greene. We want to see what happens before Judge Greene. We are taking the strongest position. We are moving for a special master to be appointed in that case that would consist of four State commissioners and three Federal Commissioners. We want to see what the decision is there. As a lawyer, I have to say that we have to wait on that.

We are also very strong, Senator, on the——

Senator **Specter**. Have you made an application to the court for appointment of a special——

Mr. **Burke**. Yes, we have. We have moved for a special master. We moved to intervene. We have taken all sorts of steps as rapidly as we could.

Senator **Specter**. The special master would be a seven-person group?

Mr. **Burke**. Yes. That was one of the suggestions. Henry Geller has got other suggestions on that to serve and to assist Judge Greene. We think that, if you are going to have divestiture, court jurisdiction has to remain, and we have to look at this thing as we go along. We do not feel that the case ought to be dismissed, in effect, and then we have to climb the mountain back if there are problems with divestiture.

I want to just add another point which is extremely important to us. We are concerned also that—I have stressed the arm's-length transaction. There were questions earlier about Yellow Pages. The Justice Department has taken the position that they think that this is really competitive and therefore it ought to be spun off and kept with AT&T. We do not agree with them.

When Charles Brown was before the NARUC membership, he said: "Look, it was not our idea to take the Yellow Pages away from the local companies; Justice pressed that point." I said: "Well, what if we can change Justice's mind and the court's mind?" He said: "Be our guest."

So, we very strongly feel that the Yellow Page revenue—Mr. Wunder just said it will only affect our rates by 1.2 percent or 1.5 percent. We suggested that the Yellow Page revenues ought to be left with the operating companies.

Finally, we feel very strongly that, if there is to be divestiture, the local Bell operating companies ought to be allowed to get into competition. We do not think the independent telephone companies should be free to compete while you tie up the hands of the Bell operating companies.

We also feel that there has to be service of the last resort provided by the dominant carrier in every State. There are rural telephone areas in this country where, if we are just simply going to have the kind of divestiture that is proposed, we are going to end up with a serious degradation of quality of service. I think we have to look at that as importantly as the rate structure here.

Senator **METZENBAUM**. If there are no changes, would you change your opinion with respect to whether or not the divestiture is in the public interest?

Mr. **BURKE**. Absolutely, Senator.

Senator **METZENBAUM**. What would your answer then be?

Mr. **BURKE**. My answer would be that, if the changes which we are recommending, that NARUC is recommending are not adopted, it would then not be in the public interest for divestiture to be completed. I just want to add one other point.

Senator **METZENBAUM**. Are you speaking now for the organization?

Mr. **BURKE**. Yes, I am, absolutely. We are also, I have to say——

Senator **SPECTER**. Mr. Burke, before you go off of this point, Senator Leahy has been trying to ask some questions. He has other commitments, as I might say we all do. We are going to have to bring these entire hearings to a close at about 11:30. Senator Leahy is next.

Senator **LEAHY**. Thank you, Mr. Chairman. I applaud you for your, if fleeting chairmanship, I applaud you for having these hearings. I think they are extremely important.

I hope that no one will think I am being parochial if I refer to Ms. McCarren's testimony first. It is similar to testimony that she gave in the House. I think it is extremely important testimony. I hope that it is well read both in the House and the Senate, especially because it brings a rural perspective that is vitally needed in this. Ms. McCarren, you said in your statement a couple of things that I noted particularly. You said in this era of New Federalism, this consent decree is an aberration because it takes decisionmaking authority away from local communities and centralizes it within agencies of the Federal Government, a matter that strikes a great deal of concern of certainly any Vermonter.

You also state on page 7 a couple of lines that I really noted. You said that it appears that the punishment for the anticompetitive acts of AT&T is being visited upon the BOC's by this consent decree.

I happen to agree quite a bit with you on both of those. After divestiture, as I said in the statement that I inserted for the record, AT&T and the BOC's should have the same adversarial relationship that any two unrelated businesses have in the same general field. Of course, that is where I begin to get concerned because AT&T is going to be principally responsible for development of the divestiture plan that has to be presented 6 months after entry of an order in Judge Greene's court.

Independent BOC's do not even exist yet although immediately after birth they are going to represent the bulk of the present AT&T assets.

While I ascribe the best of intentions on everybody's part, you really have a very strange hybrid situation replete with at least the potential of, if not conflicts of interest, at least conflicts of concern. I am not sure all of this is going to come out in just a consent decree.

I might ask Chairman McCarren this. Aside from the issues that could be settled by the wording of the decree that is going to be entered in Federal court, what do you see as the major issues that should be taken up and dealt with by the Congress? What would be the most pressing of those that should be dealt with by us?

VIABILITY OF BOC'S

Ms. **McCarren**. I think the most pressing issue is a structuring of divestiture that does exactly what you said: leaves the BOC's in a competitive posture, leaves them with the ability to compete. I said this earlier. I am just repeating myself. The biggest problem with the consent decree as it is now structured is that the BOC's are limited in what they can get into.

I, for one, as a State regulator are not particularly afraid of dealing with a BOC that can compete. I think we have heard that from Mr. Wunder. He says you cannot let the BOC's compete because there will be cross subsidization; there will be all kinds of problems. I think, as a State regulator, we have to deal with that problem. I would rather trade that problem for the problem of the BOC that has absolutely no revenue stream.

Senator **Leahy**. But you do not see that coming out of a consent decree?

Ms. **McCarren**. No, it is not.

Senator **Leahy**. You said that is going to require us?

Ms. **McCarren**. That will certainly require congressional action. All of the issues that we talk about, access charge, valuation, Yellow Pages, all to a large extent flow from that central issue.

I am just going to give you a figure on the Yellow Pages because everyone talks about that a lot. For New England wide it is $90 million. It is $90 million in revenue for New England Telephone, of which there are five States; and $45 million of that is contribution above cost. Comparable figures for Vermont are $3.4 million and, I think, around $1.2 million. That will give you some idea on Yellow Pages.

All these little things: it's only 1 percent; it's only 3 percent; it's only 5 percent. You have to look at the big picture. And in that big picture no one knows the answer at this point. No one really has the answer as to what it is going to cost local exchanges. But it is not going to be 5 percent; we all know that.

Senator LEAHY. You make some very good points. Also, in your testimony you refer to a couple of companies up in the Northeast Kingdom. I point out to everybody here who is not familiar with the Northeast Kingdom, Mr. Chairman, that is the northeastern part of our State. It is very, very beautiful and very, very rural. It is under 12 feet of snow right now. The second Thursday in every July they have a glorious summer there. It is one of the most beautiful spots you could ever go to but also one of the most rural, very similar to some of the areas in your own State. Quite frankly, the kinds of problems that they are going to be facing and the kinds of problems that Ms. McCarren and anybody else on a public utility commission looking at that are going to face, I do not see how they could ever be answered under the consent decree.

Ms. McCARREN. I agree with you, Senator. They cannot be answered under the consent decree now.

What Mr. Burke talked about is ways to ameliorate the problems caused by the consent decree. I would urge Congress to step back, take a look at the same goal, competition and deregulation, which is where we all want to end up; but look at it in a manner that insures we are going to have some competitors out there and not go back again to the situation where AT&T reintegrates itself backward into the local exchanges.

I think that is really the sum of the problem. We could spend all day talking about all the pieces to that problem, but I think that is the sum of it.

Senator LEAHY. I wonder if I could just ask one more question and place the rest in the record. Looking at it now a little bit from the other side, is it really realistic to think that the State PUC's would be restrained in their access charges if they obtain that authority because of the fear that excessively high charges would drive business away from the local loop? Could that happen today?

ACCESS CHARGE

Ms. McCARREN. Bypass of the local loop can happen today. It is not happening in Vermont, but it is happening in New York in Manhattan. What I tried to point out was that you will hear us as U.S. Senators that the petty politics or whatever of local State regulators will make them make bad decisions about access charges because they are not seeing the national picture.

I would say to you in response to that two things. One is that any decision a State regulator makes with respect to an access charge has got to be consistent with the economics of what is happening. The economics are that if a carrier can do a bypass at a cost less than the access charge, they are going to do that. So, a

State regulator cannot set an access charge above that. That is a really important point.

The second point is that, if the FCC sets the access charge, they will set it on a national level as low as possible and without concern for the local conditions.

Senator **Leahy**. Thank you. I appreciate that. Mr. Chairman, I will submit my other questions for the record.

Senator **Specter**. The record will remain open for that purpose.

I have one final question for you, Chairman Shanaman. What is your best judgment as to how much rates will increase if the divestiture goes through?

Ms. **Shanaman**. I guess I would have to concur with the generality of the 200 to 300 percent.

Senator **Specter**. Over what period of time?

Ms. **Shanaman**. I will accept what the FCC has said, which is over a 5-year period of time. I think that the number is somewhat imprecise simply because we do not have the true parameters.

Senator **Specter**. Chairman McCarren, what would your judgment be on that same question?

Ms. **McCarren**. I do not disagree with Chairman Shanaman. I think that none of us really know. The reason we do not is we do not know the true flow—we know the flow of dollars for separations, but we do not know how much above that is above cost, if any. And that is the old subsidization problem.

I do not disagree with Chairman Shanaman. I would just postulate that none of us really know. Until there is a true, fully distributed cost study to show what local exchange really costs, we will not know the full answer to that question.

Senator **Specter**. Thank you very much, Chairmen and President Burke.

Mr. **Burke**. Could I just make one very quick comment? NARUC's national position is that we feel that there should be comprehensive legislation passed by the Congress. I do not want that misunderstood. Even though I was addressing the divestiture issue, we do support comprehensive legislation.

Senator **Specter**. Thank you. Thank you very much for that additional comment.

We will next turn to the Honorable Robert Brickman, assistant attorney general, Antitrust Division of the State of Arizona. First, without objection, we will insert Mr. Burke's prepared statement into the record.

[Material referred to follows:]

Testimony of

Susan M. Shanaman, Chairman
Pennsylvania Public Utility Commission

Thank you Mr. Chairman and members of the Committee for permitting me to appear here today to provide some information on the recently announced AT&T divestiture.

The telecommunications revolution began in 1956 with the FCC's Hush-a-Phone decision. The coup occurred on January 8, 1982 when the Department of Justice and AT&T announced the modification of the 1956 Consent Decree. The impact of "Fateful Friday" will be felt by every consumer of communications service in the country.

To encourage full development of technological advancement of telecommunications, the FCC and Congress moved toward reliance upon competition -- not regulation. The appropriateness of competition cannot now be questioned. But our zeal for competition must not obfuscate this nation's goal since 1934 -- affordable telephone service for all persons.

Competition will be beneficial. It's effects can offset a portion of any resultant increase in basic service costs. But not for everyone. In any given month in Pennsylvania, over half of residential telephone customers do not make a single toll call. The benefits of competition envisioned by AT&T, DOJ and Congress will not be apparent to those constituents.

It is clear that the settlement agreement does not adequately address some very basic issues. It remains the responsibility of Congress to safeguard the interests of ratepayers of regulated services to continue to enjoy access to high quality universal service at affordable and reasonable rates.

The communications world reeled under the news that AT&T and the Department of Justice had agreed to a modification of the 1956 Consent Decree. AT&T agreed to divest itself of 22 local telephone companies with assets of $80 billion. In return the new AT&T will be allowed to enter electronic data and computer fields. AT&T has 6 months to draft a plan of divestiture. After the plan's approval, AT&T will have 18 months to break off the local companies that serve 80% of the nation's telephone customers. It is anticipated that this actually will take effect January 1, 1984.

Remaining with AT&T will be the long-distance and toll-call network, Bell Laboratories and Western Electric. These have been the most profitable portions of AT&T. AT&T will also retain Yellow Page revenues.

Judge Greene who has presided over the antitrust suit has requested review of the agreement. He has indicated the court will permit a 60-day comment period. The Pennsylvania Public Utility Commission intends to file comments with Judge Greene.

What does the break up of AT&T mean to the communications consumer?

Most news and analytical sources agreed. The effects may be summarized as stated in the U.S. News and World Reports on January 25, 1982.

" -- New types of phone service will be offered, such as more sophisticated wireless portable phones, as local telephone companies modernize operations.

-- Business and residential users can expect bigger jumps in phone bills for local service.

-- Rates will rise at a slower pace for long distance calls, with more competitors challenging Bell.

-- Bell's entry into the computer field will quicken development of home-computer services and other equipment for sending data electronically.

-- AT&T stockholders may benefit because the company, freed by the settlement from paying subsidies to local operations, is expected to be more profitable."

The AT&T settlement accelerates the direction in which the FCC and Congress have been moving.

One of the most important facts of the divestiture involves the valuation of the assets. Because there is no reason to expect that AT&T will have any reason to advance the interest of the states, it is important that states be given the opportunity to comment upon both the valuation and method of determining compensation for assets transferred between the Bell operating assets and AT&T.

The importance of determining the fair value of the assets to be transferred cannot be overemphasized. In Pennsylvania it is estimated that approximately one-third of the present assets will be transferred away from Bell of Pennsylvania to AT&T. Since local rates are directly related to the assets retained by the operating companies, it is imperative that the assets retained are not directly or indirectly associated with providing services which are controlled by AT&T.

I believe that states should have substantial input concerning three primary areas:

(1) Determining which assets are to be transferred. There should be assurance that all of the assets concerned with the service to be provided by AT&T are transferred away from the local companies. The allocation methods are complex and extremely controversial. If the methodology understates the extent to which "AT&T Services" utilize equipment, there is instant subsidy flowing from local ratepayers to AT&T. This occurs because state regulators must, by law, permit the local companies to collect their share of the investment through rates regulated by the state commission. Indeed, there have been some persuasive arguments that cross-subsidies already exist in the current method of allocating plants which work to the detriment of local subscribers.

(2) Determining the valuation of the assets to be transferred. Once a fair allocation method has been determined, it is important that AT&T be assessed the proper price for the assets. Obviously the most straightforward method would be to value the assets at net book value. There is some question as to whether this method accurately reflects the fair market value of the assets. If book values are to be considered, the correctness of the depreciation reserve becomes crucial. Since many states have simply adopted the FCC-prescribed depreciation rates, it becomes very important that states have the opportunity to comment upon the accrued depreciation utilized to value the assets. A more imprecise, but perhaps much fairer method, would be to

value the transferred assets at fair market value or net book value, whichever is higher. In Pennsylvania we have, until recently, recognized the "fair value" of utilities in determing rates, so determining market value does not seem to be an insurmountable obstacle to us. Our input may benefit all parties. In addition, it must be recognized that AT&T should reimburse local ratepayers for new products that have been under research and development and have been at least partially financed with local rates.

(3) Compensation. Since the assets to be transferred to AT&T have been at least partially financed by local ratepayers, it is important that any compensation be easily identifiable and recognized by state commissions in establishing local tariffs. It may be important, therefore, to require all compensation to be in the form and manner which can be recognized by the state commissions.

I note, however, that the actual impact of the pending settlement cannot be assessed until the AT&T divestiture plan is submitted. If the states do not have an opportunity to comment, the court will be deprived of any meaningful opportunity for effective review. I believe, therefore, that the comment period should be held open pending review of the plan itself. More specific comments can be entered by the states at that time.

According to the Consent Decree, investment in terminal equipment will not be part of the regulated rate base. What does this mean? It means that state jurisdictions would lose all revenues for customer terminal equipment. They also would lose the opportunity to assign a proportionate cost of terminal equipment through the separations process to interstate revenue requirements.

There is also a valid concern among some state regulators that customers in rural areas will no longer have the ability to readily obtain the basic phone set currently provided by the local phone company.

All interexchange calling, whether intrastate or interstate, would be brought under the jurisdiction of the FCC. However, exchanges as we know them today would be redefined, probably to comport with the various standard metropolitan statistical areas. Thus most intrastate toll calling regulated by state commissions would become subject to FCC regulation. These changes would significantly expand the scope of federal regulation. The proposal would reduce the scope of state regulation and leave state regulators with a very limited basis of regulation -- namely, Exchange Network and local Private Line Services.

From the perspective of a state regulator, jurisdictional boundaries should recognize the political entities in which the customer resides and to whom the regulators are responsible for the rates and service within the boundaries. Currently, boundaries meet this criteria for the regulatory agencies exercising local exchange regulation as to rates and service. New developments in extended area of service (EAS), optional extended area service, and local community interest calling are keyed primarily to local and area services based upon political boundaries, such as police and fire protection, medical and social services, school districts and churches.

State commissions have proven to be highly capable of regulating intrastate interexchange services. There is no evidence to indicate that the state agencies would be any less capable of performing regulatory functions mandated by future legislation. The states have the necessary staff and expertise to perform parallel functions of the FCC for intrastate interexchange carriers. The ability to evaluate the extent of competition in intrastate interexchange markets in order to determine when deregulation or continued regulation in some form is appropriate should be granted to the states.

The solution to this problem is to have the state retain intrastate toll jurisdiction under guidelines established by a federal-state joint board to ensure some uniformity.

The states should encourage competition and deregulation of carrier services in the intercity market when it will serve the best interest of the general public. States should retain the jurisdiction over intrastate toll services to the extent, and for the duration, that comparable services are regulated by the FCC.

Certainly another important reason for the states to retail total intrastate jurisdiction is that the many optional EAS plans are largely related, at the present time, to the intrastate toll operation. In many areas these optional extended service plans are so universally used that the public equates them to universal basic service also. Transfer of intrastate toll jurisdiction to the FCC would, in many instances, make extended service and optional service plans too costly as to make them unaffordable to the public.

Regardless of the method employed for exchange boundary determinations, the provision of optional and no-optional extended calling arrangements to contiguous and nearby exchanges should continue to be wholly under state commission jurisdiction.

Yellow page revenues in Pennsylvania were $75 million net of expenses in 1980. Their loss to ratepayers would increase bills about $1.05 per month for most urban areas. The revenue loss would be somewhat less in the suburban areas.

Yellow pages are not a national interest. They primarily provide local advertising by local businesses or professions for local consumers.

Yellow page advertising is not a competitive service. Certainly, the many rural areas in the Commonwealth will not constitute a prime market for nationwide competitors.

Yellow pages are a primary function of white page listings. Therefore, if yellow page revenues are phased out of state jurisdiction, as proposed under the Decree, then the BOC's should be permitted to charge yellow page vendors for listings.

The Consent Decree states that nondiscriminatory access charges shall be assessed upon all interexchange carriers that interconnect with the local exchanges. The document is silent, however, as to which agency should be assigned the responsibility of setting the access charges.

The purpose of the access charge should be to ensure that intraexchange carriers are fairly compensated for the costs of distributing interexchange-telecommunications through the use of intraexchange services and facilities in order to ensure the continued universal availability of basic telecommunications service at reasonable and affordable rates.

Since the access charges will ultimately effect maintaining universal service at affordable rates, it is only reasonable to expect that these charges be subjected to state jurisdiction. Of course, FCC or Joint Board may wish to propose certain guidelines for the states to follow.

Should the states gain exclusive jurisdiction over all exchange access charges, the legislation should give the states enough latitude to determine how the monies should be used. For instance, the charges could be used to mitigate against large increases to local subscribers as a result of the loss of subsidization by toll revenues. Without this latitude, access charges recoup only actual costs; thus it is conceivable that local basic rates may double or even triple.

Some of the ratepayer impact of the AT&T settlement can be mitigated by permitting state regulators to establish access charges for AT&T and other carriers to use the local network system; by assuring that the assets transferred to AT&T are valued at the best economic price for the local companies; by assuring that all assets directly or indirectly associated with providing services which are now controlled by AT&T are transferred to AT&T; by requiring that all compensation for the assets be in a form and manner which can be recognized by state commissions, by retaining intrastate toll rate jurisdiction with state commissions; by retaining state jurisdiction of yellow page revenues, or in the alternative, charges to yellow page vendors for listings; and lastly, by permitting local companies to provide services other than dial tone.

Let me share with you some of the real concerns this leaves me with as a Commissioner responsible for the regulation of 58 telephone companies in Pennsylvania. I believe local regulators have a unique obligation to assure the continued availability of high quality telephone service at reasonable rates that Pennsylvanians today take for granted, and for which we on the Public Utility Commission will continue to have regulatory responsibility.

The local exchange or local distribution segment of the industry represents a major portion of the total communications business and certainly, as the heart of the telecommunications sytem, must have service and financial viability. With the industry functioning in a dual mode of regulation and deregulation, looking for solutions which are best for the general public is not simple.

I feel strongly, for example, that the urgencies of rapid developments in telecommunications does not exempt us from continuing to evaluate the impact of competition, not merely the question of whether competition is feasible in this or that segment of telecommunications. The more basic question of the long-term effects of these issues on the public at large is how it is likely to affect the adequacy, dependability and availability of telephone service and the price the public will have to pay for it. I say this because our responsibility as regulators is to the public at large, not to some customers but all customers and not only to today's public but tomorrow's as well.

Certain benefits of past regulatory policy are obvious. The goal of universal service -- a telephone in virtually every home -- has been achieved not only through technological advancements, but through a rate structure that has favored the home user. Our goal in Pennsylvania, like most state regulators, has and continues to be one of keeping rates for basic residence exchange service within the reach of most households. This has been achieved as optional services were priced above their cost, providing a significant contribution to support of exchange service. Deprived of this contribution, which is truly a cross-subsidy from competitive services, local exchange rates would have to go up. To put it another way, if the nation's telephone companies are deprived of the contribution or stream of revenues now provided by discretionary services, they will face the necessity of increasing the average residence customer's bill for basic service substantially. Some studies estimate local rates could almost double. The cliche, "as toll rates go down, local rates go up," grossly underestimates the gravity of the problem. Some of you may not realize that almost half of the customers in Pennsylvania in a given month do not make toll calls.

The consequences of significant increases in local rates to people on low and fixed incomes need not be spelled out. That so drastically an increase might be necessary is disturbing. I use the illustration, however, to demonstrate the direction the price of basic service appears destined to move under competition.

I seriously question that the public, already alarmed over rate increases caused by inflation, will be disposed to welcome further increases caused by the introduction of competition in telecommunications. They are likely to feel the introduction of competition should make it work the other way around.

I do believe most citizens are still largely unaware of the issues involved or what is at stake for them in terms of the eventual outcome.

One thing is certain. Vested economic interests should not alone define the parameters of the debate on telecommunications policy. A proper balance can only be achieved when the public becomes actively involved. We are concerned here with nothing less then the national interest. The crucial questions do not revolve around how big the slice of the communications pie each participant is able to carve out. The real questions center around how to ensure that the benefits of this revolution are made available to as many people as possible while maintaining basic telephone service that has a reputation of being the best in the world in cost and quality.

I am sure I have raised more questions and possibly additional concerns here today by briefly outlining some of the major issues facing the telecommunications industry, legislators, regulators and customers. But I believe these questions and concerns must be addressed and answers must be forthcoming.

-- Will competition eventually necessitate a reduction in toll rates?

-- How will customers who don't make toll calls benefit by reduced toll rates?

-- What do I tell basic residence customers when they ask how they benefit from competition?

-- In this changing environment, who does the customer contact to get a telephone?

-- To get it installed?
-- To get a dial tone?
-- To get it repaired?
-- To get it relocated?
-- To get the best possible rate for an intercity call?
-- How many bills will a customer get?
-- From whom?
-- Where will he pay his bill or bills?

-- How much will local telephone companies have to charge to install new service with all the cost being expensed rather than capitalized?

-- Who does a customer complain to about poor transmission when he is talking over his ITT instrument in a General Telephone served exchange, over MCI provided intercity lines to a Bell Telephone served exchange with a customer using a Radio Shack phone?

-- Who is responsible for the overall quality of service?

-- What effect will the changing environment have on small telephone companies?

-- Will they remain financially viable?

-- Who picks up the pieces if a small independent telephone company fails?

-- And finally, when the dust settles, what will be left to regulate and who will regulate it?

Developing answers to these multi-faceted questions will be difficult but communicating and convincing customers of the answers will be even more difficult.

The immediate future will truly be a time of transition in the telecommunications industry. Competition will indeed have beneficial effects upon the technological communications revolution. Although many aspects of telecommunications regulation and policy remain uncertain, the Pennsylvania Public Utility Commission's objective is clear -- that is to assure the continued availability of high quality telephone service at reasonable rates for all Americans.

Thank you.

APPENDIX A

Effect of Per-Line Change in Interstate Separations on Individual Line Residence Rate in Largest Bell Exchange in Each State 3/

Assumes elimination of weighted minutes of use (SPF factor)
under Ozark Plan with substitution of SLU factor and
elimination of terminal equipment and station connections
from the allocation of subscriber plant costs to interstate operations
Bell Company Exchanges, Year 1980 Basis

State and City	Monthly Ind. Line Residence Rate 1/ 7/1/80	Monthly Effect of Separation Change 2/ Year 1980	Rate adjusted for Separation Change	Percent Increase
Alabama, Birmingham	$13.50	$ 4.92	$18.42	36.4%
Arizona, Phoenix	9.50	9.50	19.00	100.0
Arkansas, Little Rock	9.95	5.92	15.87	59.5
California, Los Angeles	6.00	5.25	11.25	87.5
Colorado, Denver	8.00	9.08	17.08	113.5
Connecticut, Hartford	8.77	6.00	14.77	68.4
Delaware, Wilmington	7.95	6.08	14.03	76.5
District of Columbia, Washington	9.65	8.08	17.73	83.7
Florida, Miami	12.30	9.83	22.13	79.9
Georgia, Atlanta	11.85	6.66	18.51	56.2
Idaho, Boise	7.00	7.25	14.25	103.6
Illinois, Chicago	5.55*	4.83	10.38	87.0
Indiana, Indianapolis	11.25	4.08	15.33	36.3
Iowa, Des Moines	9.10	5.08	14.18	55.8
Kansas, Kansas City	7.35	5.58	12.93	75.9
Kentucky, Louisville	11.44	4.25	15.69	37.2
Louisiana, New Orleans	11.10	5.00	16.10	45.0
Maine, Portland	10.25	5.17	15.42	50.4
Maryland, Baltimore	9.42	3.83	13.25	40.7
Massachusetts, Boston	9.70	4.92	14.62	50.7
Michigan, Detroit	8.75	3.0[illegible]	11.83	35.2
Minnesota, Minneapolis	9.50	5.25	14.75	55.2
Mississippi, Jackson	14.75	6.08	20.83	41.2
Missouri, St. Louis	8.50	5.00	13.50	58.8
Montana, Billings	5.75	8.00	13.75	139.1
Nebraska, Omaha	9.45	7.83	17.28	82.9
Nevada, Reno	8.35	18.92	27.27	226.6
New Hampshire, Manchester	10.90	8.00	18.90	73.4
New Jersey, Newark	7.65	5.42	13.07	70.8
New Mexico, Albuquerque	7.85	7.33	15.18	93.4
New York, New York City	6.04#	5.66	11.70	93.7
North Carolina, Charlotte	8.55	4.75	13.30	55.6
North Dakota, Fargo	9.65	7.33	16.98	75.9

* Measured Rate, includes 80 message units

# Measured Rate, includes message allowance of $4.00 usage

State and City	Monthly Ind. Line Residence Rate 7/1/80	Monthly Effect of Separation Change Year 1980	Rate adjusted for Separation Change	Percent Increase
Ohio, Cleveland	$11.95	$ 3.42	$15.37	28.6%
Oklahoma, Oklahoma City	6.20	6.17	12.37	99.5
Oregon, Portland	8.05	6.58	14.63	81.7
Pennsylvania, Philadelphia	6.65	3.17	9.82	47.7
Rhode Island, Providence	13.00	4.75	17.75	36.5
South Carolina, Columbia	9.80	4.75	14.55	48.5
South Dakota, Sioux Falls	7.75	7.33	15.08	94.6
Tennessee, Memphis	10.80	4.42	15.22	40.9
Texas, Houston	8.15	5.33	13.48	65.4
Utah, Salt Lake City	9.17	5.42	14.59	59.1
Vermont, Burlington	10.10	9.00	19.10	89.1
Virginia, Richmond	9.55	5.50	15.05	57.6
Washington, Seattle	8.25	5.58	13.83	67.6
West Virginia, Charleston	14.83	4.33	19.16	29.2
Wisconsin, Milwaukee	9.50	3.42	12.92	36.0
Wyoming, Casper	7.79	16.42	24.21	210.8

Notes: 1/ NARUC Exchange Service Telephone Rates in Effect June 30, 1980

2/ AT&T Reply to Information Request #2 to Joint Board in FCC CC Docket No. 80-286, average interstate revenue requirement removed from interstate, per main station.

3/ In practice, the revenue requirement resulting from a shift from interstate would probably be spread in proportion to the basic rate. Business rates would have a higher increase; rates in smaller exchanges would have a lesser increase. Because of the variation above and below the large city residential rate it is probable that these rates would pick up close to the average increase per line.

APPENDIX B

IMPACT OF DEREGULATION AND SEPARATIONS CHANGES UPON A REPRESENTATIVE INDEPENDENT PENNSYLVANIA TELEPHONE COMPANY *

The following figures pertain to only one Company (United Telephone) regarding the impact of deregulation and separations changes, but are probably representative of the industry.

General

1.	Number of Subscribers	217,971	
2.	Average Local Monthly Service Charges	Res. $9.03	Bus. $21.39
3.	Average Long Distance Monthly Charges per Main Station	$19.21	
4.	Average Charges for a Station Connection	$50.21	
5.	Total Station Connections per annum	$2,931,891	

Revenue Requirements (Monthly)

1.	Loss of Separations Support from Elimination of Toll	$3.24
2.	Loss of Separations Support from Deregulation of Terminal Equipment	$2.10
3.	Loss of Separations Support from Deregulating Inside Wiring	$1.91
4.	Loss of Support from Yellow Page Advertising	$1.00
	Total Monthly Revenue Requirement from Loss of Above	$8.25

Impact of Capital Recovery Changes

For this Company the depreciation expenses per annum would go from $19,500,000 to approximately $22,500,000 as a result of moving from straight line vintage grouping to equal life grouping and the use of the remaining life method of determining lives.

*Average local monthly residential service charges will approximately double.

APPENDIX C

POSITION ON IMPORTANT TELECOMMUNICATIONS ISSUES

The following points represent important consumer/ratepayer related issues and policy goals which must be addressed both by the proposed AT&T Anti-Trust Settlement Agreement and pending Federal telecommunications Legislation:

1. The Bell operating companies must be divested intact and allowed to provide their customers with the same facilities, services and equipment prospectively as all other local telephone operating companies are able to.

2. The division and transfer of AT&T assets and capitalization must involve meaningful state commission review and approval

3. Access charge setting must be left to the control of individual state commissions, subject to appropriate statutory guidelines and reviewable by the FCC or a joint board.

4. A requirement should be adopted to ensure that one regulated "provider of the last resort" exists for each sector of end-to-end basic telephone service, until such time as competition exists in a given locality for a particular service or facility.

5. Revenues from yellow page directory advertising must be available for consideration in setting local phone rates.

6. State commissions must retain the ability to set intrastate toll rates and depreciation rates on intrastate plant.

7. Local Bell operating companies must receive renumeration for tax benefits, research and development and patent royalties transferred to AT&T under a divestiture arrangement.

8. A transitional measure is required to prevent the harmful bypassing of the local network by AT&T until sufficient competition exists to ensure the continued viability of the local exchange.

Attached is a list of reasons in support of the above points.

EXPLANATION OF POSITION
ON IMPORTANT TELECOMMUNICATIONS ISSUES

Point 1. The Bell operating companies must be divested intact and allowed to provide their customers with the same facilities, services and equipment prospectively as all other local telephone operating companies are able to.

Reasons:

A. The consuming public is well served by a financially viable and stable local exchange service. The financial integrity of the spun off BOC's will be enhanced by keeping them whole and letting them compete.

B. Customers of the BOC's should be able to get the same equipment and services as all other telephone customers can. There is no logical reason why a General telephone Company Florida subscriber can receive local, long distance services and CPE while, across the street, a Bell operating Telephone Company subscriber cannot.

C. Preventing the BOC's from providing competitive intercity services or CPE is itself anti-competitive. To stimulate competition, the Bell operating companies should be encouraged to compete with AT&T, other telecommunication organizations and amongst themselves once divestiture is accomplished.

D. The dangers to ratepayers from incorrect asset valuation and division are largely eliminated by this approach. Any asset transfer would be carried out in an arms length transaction thereby assuring a fair representation for the monopoly ratepayer/BOC joint and common interests.

E. AT&T Chairman Brown has indicated he is not opposed to this proposition if DOJ would agree to the approach.

F. This arrangement avoids many of the otherwise severe financial and service hardships on the customers of the BOC's.

G. The severe limitation on the future business opportunities available to the BOC's will raise capital costs, increasing local rates proportionately. Improper or imprudent valuation of assets and changes in capitalization will place a similar upward pressure upon capital costs for local operations with resulting rate increases. Limiting the BOC's to the least profitable part of the business will negatively impact their financial integrity and ability to continue providing high quality service at reasonable rates to their customers.

Point 2. The division and transfer of AT&T assets and capitalization must involve meaningful state commission review and approval.

Reasons:

A. The state commissions must participate on behalf of their ratepayers interests in the divestiture process of defining and valuing assets and sources of funds. The determination of the value assigned to the transfer is vital to local exchange rates being adequately compensated for such property.

B. State commissions are already knowledgeable about the assets involved. The states work with these items on a day-to-day basis. Since state commissions are intimately familiar with the assets subject to their jurisdiction, they should oversee the disposition of those assets and operations.

C. Undervaluation of assets or improper allocation, division or disposition of deferred tax credits, research and development activities, depreciation reserves, patent royalties and goodwill, all accrue to the disadvantage of local BOC customers and will have to be recovered in higher local rates.

Point 3. Access charge setting must be left to the control of individual state commissions, subject to appropriate statutory guidelines and reviewable by the FCC or a joint board.

Reasons:

A. Access charges are crucial to support for local exchange service.

B. When access charges are too low, local customers are hurt. When access charges are too high, bypass will be encouraged to the detriment of local ratepayers.

C. The appropriate level of local exchange support can only be set with awareness of local conditions. The states have a greater capacity for awareness than the FCC in this regard.

D. With 1,500 companies and 17,000 local exchanges, the FCC/TJB cannot review each with any sentitivity to local conditions.

E. A split authority between states and FCC/TJB is inherently inefficient.

F. Present separation procedures recognize differences in cost of service between localities. This should continue in access charges, but is unlikely under a FCC/TJB approach.

G. Revenues from access charges must initially offset the lost revenue currently received from the separations and settlements process. This is the key to continuing universally available local telephone service and preventing a doubling in local phone rates.

H. Locally set access charges should be consistent, however, with national policy guidelines.

Point 4. A requirement should be adopted to ensure that one regulated "provider of the last resort" exists for each sector of end-to-end basic telephone service, until such time as competition exists in a given locality for a particular service or facility.

Reasons:

A. Customers must be assured of available end-to-end service, including CPE, where competition does not exist sufficient to meet the need for basic telephone service.

B. Customers should have the option to lease a plain telephone set as part of basic local phone service. This will protect the customer from a "not our fault" runaround by multiple suppliers of service and equipment.

C. Customers may suffer from split responsibility for basic core service. The option to look to the local phone company as the responsible entity for basic core service should continue. For many customers, the denial of the right to secure full basic service will be a degrading of the telephone service.

D. Universal telephone service in rural or other variant markets will certainly be jeopordized by failure to include the "provider of last resort" cushion for the CPE and interexchange segments of phone service.

Point 5. Revenues from yellow page directory advertising must be available for consideration in setting local phone rates.

Reasons:

A. Directory advertising revenues are the product of local exchange telephone service and should be applied to keep basic rates affordable. There is no persuasive reason to deprive local customers of this lucrative revenue source.

B. Yellow pages are not now truly competitive. This fact is made clear by the huge profit margins presently found in yellow page operations. These monopoly profits should be left with the exchange operation to keep local rates reasonable.

C. The exchange telephone company enjoys an advantageous position with respect to the information necessary to compile a yellow page directory. Yellow pages are an adjunct of white page listings which must necessarily remain part of local exchange operations.

D. All Americans have been indoctrinated to "let their fingers do the walking." This powerful medium is "made" by the telephone customer who should continue to reap the benefits on the phone bill.

E. Yellow pages are part of the local operation for the BOC's and all local operating companies. The suggestion that a revenue stream from sale of listings would equal the present and ongoing directory listing revenue stream is fallacious. Yellow pages must remain with the BOC's and all local telephone companies or local phone rates will experience an unnecessarily severe rise as a result.

Point 6. State commissions must retain the ability to set intrastate toll rates and depreciation rates on intrastate plant.

Reasons:

A. Federal Regulation of intrastate toll service is not in the best interests of ratepayers. Each state can better recognize the varying circumstances affecting costs and can better respond to the need of each telephone company to recover these costs by balancing the demands upon local revenues and those of intrastate toll service.

B. Rather than leaving the provision of intrastate toll calling entirely in the hands of competition, this service should remain the obligation of the principal state certificated telephone company to assure that service is available to all customers on a universal basis, at least until sufficient competition exists.

C. Provision of Extended Area Service will be disrupted by the juridictional change for intrastate toll. This is a matter of great local concern to customers, along with resulting local rate impacts. Decisions on local services and rates belong with the states if the decisions are to be made with a sensitivity for local concerns and characteristics.

D. By utilizing the extensive state regulatory mechanism already in place, the need is eliminated for increased FCC staffing or resources and convenient state forums are preserved to hear and resolve consumer grievances.

E. Ratepayer interests will be protected by allowing state regulators to retain the flexibility for independently determining which depreciation methods and rates are appropriate under the unique circumstances in the states.

F. Depreciation reflects local operating costs, is based on actual local experience and clearly impacts local rates. An ability to review arbitrary or capricious depreciation rate setting by a state commission already exists in the state court system.

Point 7. Local Bell operating companies must receive renumeration for tax benefits, research and development and patent royalties transferred to AT&T under a divestiture arrangement.

Reasons:

A. The cost of research performed by Bell Labs has historically been funded through license contract expenses paid by local ratepayers. The operating companies now continue to pay a percentage of Bell Labs costs.

B. Local ratepayers must receive a pro-rata, time value payback share of the income from this R & D for a period of years.

C. Ratepayers must also receive the benefits of current R & D which have not yet been patented. The ratepayer funded systems development from current R & D must be allocated the same as patents.

D. Deferred income taxes are presently cost free capital for the operating companies. Under the normalization process, these tax savings are solely due to the ratepayers contribution at the statutory tax rate while the company actually pays a lesser rate. The source of funds (i.e., cost free capital), therefore, must be considered if the interests of local telephone consumers are to be protected during a division or transfer of assets involving the local operating company.

Point 8. A transitional measure is required to prevent the harmful bypassing of the local network by AT&T until sufficient competition exists to ensure the continued viability of the local exchange.

Reason:

A. Failure to prevent a wholesale bypassing of local exchange facilities by AT&T during the transition period may jeopardize the continued economic viability of local exchange service at affordable rates. However, as competition develops AT&T would be treated as any other competitor.

B. Premium local exchange business is siphoned off in the bypass process. The benefits of this process apply only to a select group of users, at the expense of the general body of ratepayers.

C. Cost savings and quality of service improvements associated with technological advance will be diverted from the public network through bypass. These advances should be made to serve the interests of all telephone consumers rather than those of just a communications elite.

TESTIMONY OF V. LOUISE McCARREN
CHAIRMAN OF THE VERMONT PUBLIC SERVICE BOARD

Thank you for the opportunity to present to you my concerns about the proposed divestiture of the Bell System. My name is Louise McCarren, I am the Chairman of the Vermont Public Service Board. My comments are my own and not those of the Administration of the State of Vermont.

In developing my remarks my staff and I met and, after a great deal of debate and discussion, decided the following issues were of primary concern. Though the concerns expressed here have also been expressed by many others we reached the same conclusion without considering the positions or opinions of others.

Our focus was to insure the viability of the BOC's and to facilitate competition in the communications industry in Vermont. As a regulator, my goal is to insure that the people of the State of Vermont receive the widest range of services and new technology at the lowest possible cost and in a timely manner. It is also my responsibility to protect the availability and affordability of basic exchange service in rural areas. The new technological era in telecommunications can best be ushered in in a competitive, deregulated environment. However, the transition to deregulation must occur only when competition exists and at a pace and under conditions that maintain universal and affordable service.

My first observations deal with the proposed consent decree entered into between the United States Department of Justice and American Telephone and Telegraph Company. In this era of New Federalism this consent decree is an abberation because it takes decision making authority away from local communities and centralizes it within agencies of the federal government.

My first concern is over the abandonment of the separations process and the concomitant controversy over establishment of access charges to the local exchange network.

The separation process allocates a portion of the revenue generated by interstate tolls to local exchanges. The consent decree not only forbids separations as it now exists but forbids its re-emergence. The proposed consent decree dissolves the separations process and precludes its re-emergence in any form, presumably barring any form of pooling and redistribution of access charges. At the same time, it requires that any access charge to the local exchange be cost based. The combination of the abandonment of separations and the explicit requirement that any access charge be cost based is very troublesome, for in combination the effect is to eliminate any flow of money from interstate toll revenues to basic exchange and to rural areas. This flow of money has assured universal service at reasonable rates in accordance with the clear legislative mandate of the Communications Act of 1934.

The present separations process compensates local exchanges for the use of their facilities in completing interstate calls. Though the theory advanced by AT&T that local exchange rates have been heavily subsidized by interstate tolls is, in my view, a myth so often repeated that it has almost become reality, separations does make contributions to exchanges on a methodology that will not survive under a stringent cost-based system. This flexibility previously afforded by the separations process needs to be continued to insure universal service at affordable rates, and has been recognized both in H5158 and S898 in the proposed pooling process and limitation of basic exchange rate differentials throughout the country for small exchanges.

By requiring explicitly that any access charge be cost based, the consent decree has established the potential that the entire cost of local loop and other non-traffic sensitive equipment will be allocated entirely to basic exchange rates. This could result in all non-traffic sensitive costs being included in the basic exchange rate and non recovered through interexchange tolls, thus possibly sharply increasing basic exchange rates.

This situation will exist because under the consent decree, the F.C.C. will quickly assert jurisdiction over the access charge. If the F.C.C. has such exclusive jurisdiction, the powerful interstate carriers will lobby the F.C.C. to adopt "cost based" theories that maintain the access charge as low as possible, possibly to the detriment of local communities. This is an undesireable result because it takes away from the states the flexibility they need to gradually make changes toward a completely competitive environment while reflecting the needs of local communities.

The following is the estimate provided by New England Telephone & Telegraph Company of the revenue effect of the local portion of ratepayers' bills due to the loss of separations stemming from the elimination of interstate toll contributions per main station per month:

Maine	$3.14
Massachusetts	2.74
New Hampshire	4.73
Rhode Island	2.59
Vermont	5.64

These dollars must be replaced either by revenues flowing from the access charge or by increases in basic exchange rates.

State regulatory agencies should have jurisdiction over the access charge because they will be able to reflect the interests of their communities and because they are familiar with the personnel, books and records of the local BOC's and with the peculiarities of their local areas. If a level access charge is set for all exchanges by the F.C.C. at one time there will be an abrupt change and possibly substantial dislocations. The transition can be made by state regulators in a manner that both encourages innovation and helps insure universal service.

The argument that state regulators should not be allowed to set the access charge because they will be motivated by demands of local subscribers to maintain artificially low basic exchange rates or, worse, are motivated by local politics, must fail. The access charge is limited by the market - it cannot be set any higher than what it would cost for an interexchange carrier to provide the same local exchange service. That is, it is the potential for bypass of the local loop that will cap any access charge sought to be implemented by state regulators.

The second area of concern is the definition of exchange. The consent decree requires the Bell System initially to define this with the approval of Judge Greene. Any subsequent change in the definition of exchange must first be approved by the United States district Court for the District of Columbia. The definition of exchange should, instead, be left to the state regulator who understands local geographic, social and economic boundaries and who can respond to changes in local conditions. As an example, we presently have before us a petition by approximately 80 residents of East Charleston, Vermont (in the Island Pond exchange, of 729 subscribers), to be combined with the exchange containing West Charleston, Vermont, (now in the Morgan exchange having 573 subscribers). Despite the best efforts of a judge in Washington, it would be impossible for him to resond to the needs of local communities. It would also create a severe hardship for rural communities to effect change through a federal court locaed in Washington, D.C.

A third concern is the timing of the separation of the BOC's from AT&T. The scheme established by the consent decree is for the assets of the BOC's, including personnel, to be transferred to AT&T and then for the separation of the BOC's to take place. If the separation is to leave the BOC's in a viable position it seems it would be more appropriate first to separate the BOC's and then to transfer the assets. After the separation of the BOC's the transfer of assets could then take place under conditions that more closely approximate the open market with all interexchange carriers, including SPCC, MCI, SBS and AT&T bidding for the customer premise equipment and interexchange facilities.

The assignment of assets should be done to ensure that exchange service is provided in an efficient manner rather than by an arbitrary allocation that may create the very anti-competitive environment the consent decree seeks to remedy. The present scheme mandates the transfer from the BOC's to AT&T under conditions that are adverse to the BOC's and not at arms length.

Regardless of whether the BOC's are spun-off first, the state regulatory agencies should have final approval and control over the transfer of assets. This is recognized by the Department of Justice in the Impact Statement. State regulatory agencies also should decide what equipment needs to be transferred from the BOC's to accomplish the intent of the consent decree. The consent decree implies all Class 4 toll centers should go to AT&T. Both Class 4 Central Offices (toll centers) and Class 4/5 Central Offices (machines which offer both local service and toll service) should be part of the BOC's. The Class 4/5's should be part of the BOC's because a Central Office switching machine cannot be physically divided and because it provides service to local exchanges. Not including Class 4 toll centers in the assets of the BOC's would give AT&T an anti-competitive edge over other common carriers, because other common carriers would have to create transmission links into each class 5. The logical entity would be a class 4 toll center and its tributary class 5 end offices.

A fourth concern is the allocation of benefits of patents and research conducted by Bell Laboratories and Western Electric, paid for by the BOC's from the licnese contract fee. The consent decree does not provide for any flow of benefits of this work to the BOC's. Perhaps a transitional period long enough to cover existing patents - perhaps 15 years - should be established during which royalties flow [illegible] BOC's for the patents.

A fifth concern is that the financial viability of the BOC's may be dramatically reduced because of restrictions being placed on them - particularly their inability to compete in the future world of communications. These restrictions may well make the BOC's less attractive in the financial community, raising their cost of capital and debt and the cost of their service and products.

The above comments go generally to the effect of the proposed consent decree on local telephone rates, and assume that the consent decree as it now stands will be implemented. The consent decree, however, was developed from a very narrow perspective: the antitrust concerns of the Department of Justice. It does not embody the mandate of the Communications Act of 1934 of universal and affordable service.

It appears that the punishment for the anti-competitive acts of AT&T is being visited upon the BOC's by this consent decree. Under this decree it is possible that the BOC's will be left unable to compete and gradually wither and die. This is not in the best interests of either ratepayers or the BOC's. The consent decree limit the BOC's to providing only exchange and natural monoply services and forbids them from competing in non-exchange activities. The local exhcange as we know it today will be obsolete in the future, replaced by technology being developed today. This very point was made by NET in its 1980 Depreciation Rate Study, Introduction, Page 7, in which it stated that "if technology provides more economic modes of communications than are currently in use, such as cellular radio systems, entrepreneurs will be permitted free entry to compete for local exchange service."

Any new exchange technology which develops which provides either more than exchange service or access service may not be provided by the BOC's under the consent decree. However, AT&T and any other competitor, including the existing independent telephone companies, will be able to offer these services. If competitors can provide basic exchange and access services but the BOC's cannot diversify into competitive fields they may be left with only the marginal business - causing large increases in the regulated rates to some areas.

This will be perceived by knowledgable investors, thus creating from the very beginning a problem obtaining capital on favorable terms for the BOC's. In the end, with the BOC's market erroded by AT&T's cellular and Satellite services, we return full circle to an integrated AT&T with both local and toll service, but now unregulated, and free of the obsolete exchange equipment.

A different plan, one that allows the BOC's to compete, is needed. Perhaps the BOC's should be split off intact from AT&T. All assets, including CPE, exchange equipment and personnel could go with them and they could be free to compete and adjust to market conditions, including the provision all new exchange technologies. To hamper unnecessarily the BOC's will not only lead to their demise but will create a situation where the independent telephone companies, of which there are eight in Vermont, are free to enter new fields and compete with the restricted BOC's on terms that are grossly unfair.

The potential for cross subsidization created by one entity providing both regulated and non-regulated services and products would exist under this plan. It can be reduced by strict accounting policies and agressive regulatory oversight. Under the consent decree AT&T will be providing both regulated and unregulated services and produces, at least on a transitional basis, so the prospect of the BOC's doing the same in the future should not be disconcerting. The consent decree appears to pose a greater risk of allowing AT&T to compete against the BOC's and, over time, drive them out of business.

UNITED STATES SENATE
COMMITTEE ON THE JUDICIARY

STATEMENT OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

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ON

THE AT&T DIVESTITURE: EFFECT ON LOCAL RATES

MARCH 25, 1982

Summary of Testimony

- The NARUC questions whether it would represent sound public policy to allow parties to the AT&T antitrust suit to dictate the resolution of issues which transcend the relatively narrow scope of the antitrust laws. Such decisions belong with the appropriate regulatory bodies or with the U.S. Congress.

- To allow a meaningful opportunity for public review and comment with respect to the proposed divestiture, the federal district court should refrain from approving it until AT&T's reorganization plan has been submitted in its entirety and Tunney Act comments have been received regarding all of the plan's potential impacts.

- With respect to substantive provisions, the divestiture proposal's State regulators object to its envisioned restrictions or AT&T's divested local exchange carriers as unnecessary and counterproductive. These limitations would jeopardize the local companies' economic viability, leading to substantial local rate increases. The NARUC believes that the Bell Operating Companies (BOCs) should be divested in their current corporate forms, with all existing assets intact, and should be permitted to engage in competitive as well as regulated business activities.

- The divestiture proposal is deficient in its recognition of State regulatory authority over any asset valuation and asset transfers which involve the BOCs' dedicated assets. This State role will be critical in ensuring that the interests of local telephone ratepayers are protected, since it will be to AT&T's economic advantage to relegate as much of the cost burden as possible to the divested local carriers.

- The access charge system that would replace the current division of revenues process after the divestiture's implementation may fail to recover the same proportion of revenue for the local companies as that received under current separations procedures. This would result in dramatic local rate increases.
- State regulatory authority to establish exchange area boundaries is impermissibly delegated to AT&T under the divestiture plan. Even with Justice Department oversight of AT&T's decisions concerning exchange areas, this arrangement is wholly inadequate from the local ratepayer's perspective. This is especially so for those in rural areas, where the definition of exchange area boundaries will decree how much of their everyday telephone use is considered "long-distance" and how much is viewed as local calling.

- The divested local companies should continue to provide directory advertising ("Yellow Pages"). Local ratepayers' use of this medium makes it the powerful one that it is, and they should continue to reap the benefits of such use in their basic service rates.

- Even if the court approves the proposed restrictions on the local exchange carriers' offering of customer premises equipment (CPE), all *embedded* CPE should remain among the assets of the local carriers. The only effect of allowing AT&T to retain these assets would be another serious assault on the financial posture of the local companies, making local rate increases necessary.

- The NARUC does not oppose the fostering of competition in the telecommunications industry where beneficial to its consumers as well to the industry. The goal of universal basic telephone service at affordable rates, however, must not be undercut on the undemonstrated basis that such changes may prevent anticompetitive activity. The NARUC submits that the proposed divestiture in its present form unnecessarily jeopardizes this goal.

Mr. Chairman and Members of the Committee:

My name is Edward F. Burke. I am currently the President of the National Association of Regulatory Utility Commissioners, commonly referred to as the "NARUC." I am also Chairman of the Rhode Island Public Utilities Commission, and I have served in that capacity since January 1977. Accompanying me today are Paul Rodgers, NARUC Administrative Director and General Counsel; Deborah A. Dupont, NARUC Deputy Assistant General Counsel; and Rita A. Barmann, NARUC Director of Congressional Relations.

The NARUC is a quasi-governmental, nonprofit organization founded in 1889. Within our membership are the officials who sit on governmental agencies within the fifty States and the District of Columbia, Guam, Puerto Rico, and the Virgin Islands which have authority to regulate utilities and carriers. Our chief objective is to serve the consumer interest by seeking to improve the quality and effectiveness of public regulation in America.

On behalf of the members of the NARUC, I would like to thank the Committee for this opportunity to voice our concerns with respect to the proposed divestiture plan involving the American Telegraph and Telephone Company ("AT&T"). We commend you for holding this hearing to consider the plan's impact on local telephone rates and service, as it is this subject around which the State regulatory community's concerns about the plan revolve.

As members of this Committee are well aware, the envisioned AT&T divestiture plan is a product of negotiations between the U.S. Department of Justice and AT&T in connection with an antitrust suit filed by the Justice Department in 1974. The interest of the Department's Antitrust

Division in arriving at the terms of a voluntary dismissal of their suit and a proposed modification of the 1956 consent decree resulting from an earlier antitrust action against AT&T was and remains the fostering of a competitive telecommunications marketplace. By its nature, then, the rationale for the divestiture plan is narrow in scope.

But the fundamental restructuring of the nation's telecommunications industry which would occur if the AT&T reorganization plan, as it is currently contemplated, were implemented can hardly be overstated. My remarks today will focus first on the concerns of State regulatory officials regarding the proposed divestiture as a whole; specifically, the wisdom of permitting two parties to an antitrust action to completely restructure the telecommunications industry by agreement, and the opportunity afforded the public to comment on that agreement. From there I will identify those particular aspects of the proposed divestiture which State regulators consider likely to have a significant impact upon local telephone rates and service. Ultimately at stake in the resolution of these issues is a goal which must be balanced with the goal of encouraging competition: that of universal basic telephone service at reasonable, affordable rates.

Restructuring The Telecommunications Industry By Means of An Antitrust Settlement Agreement

The NARUC's first and foremost reservation concerning the proposed divestiture is that such a fundamental restructuring of the U.S. telecommunications industry transcends those competition-related issues raised in the antitrust action which has spawned this divestiture plan. We question whether it would represent sound public policy to allow the parties to an antitrust suit to dictate the resolution of issues which properly belong with the appropriate regulatory bodies or with the U.S. Congress.

As fashioned by the Justice Department and AT&T, the Proposed Modification of the 1956 consent decree would require actions by entities (i.e., the Bell Operating Companies (BOCs)) which are subject to regulation by the appropriate State utility commissions. These State commissions have full regulatory authority to approve or disapprove the regulatory actions outlined in the Proposed Modification. By submitting the proposed divestitute to the court for entry as a modified consent decree, the parties have set up a fundamental conflict between the authority of the court over antitrust issues and the regulatory authority of the State utility commissions. The NARUC contends that the court must refrain from approving those actions which are subject to State regulatory authority.

Even apart from this jurisdictional conflict raised by the Proposed Modification, we are convinced that its implementation as currently conceived would be contrary to sound public policymaking. If approved, the divestiture proposal would represent an unprecedented instance where the desires of two parties to an antitrust action, rather than the judgment of the national legislature, suffice to completely revamp an industry of critical importance to our national defense and to the well-being of every individual in America. Such decisions should not be based only upon the relatively narrow grounds of observing the antitrust laws. Much is at stake in this controversy, and the immediate parties to it must not be permitted to resolve it--and much else, as well--in such a relative vacuum.

Opportunity for Public Comment On the Proposed Divestiture

One of the most distressing provisions of the Proposed Modification is that which would allow AT&T to reveal substantive details of the divestiture plan six full months after the federal district court approves the suit's voluntary withdrawal and the 1956 decree's modification.[1] Under this schedule, the only opportunity for public comment on the plan's terms--prior to its approval by the court, in accordance with the so-called Tunney Act procedures--will expire before AT&T is required to submit its plan of reorganization to the court. At that juncture, the court would retain jurisdiction only to assure that the plan does not depart "in any substantial way" from the mofidication's principles.[2]

The NARUC considers this manner of implementing the proposed divestiture totally unacceptable. We intend to request the district court to defer approval of any portion of the proposed modification until after the reorganization plan has been submitted in its entirety. It is clear to all who have attempted to analyze the effects of the divestiture based on what is revealed in the Proposed Modification and the Justice Department's Competitive Impact Statement (CIS) that the reorganization plan will by no means consist of marginally important details. Rather, this portion of the divestiture plan will raise substantive issues affecting State regulatory concerns as well as the public interest.

Recognizing this reality, we will also request that the reorganization plan be the subject of Tunney Act comments. To limit the public's opportunity to evaluate the proposed divestiture to a period ending before all the essential facts are known would undercut the purpose of the Tunney Act procedures and would guarantee that public comments would be reduced to an exercise in guesswork.

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[1] See Proposed Modification, p. 2.

[2] Competitive Impact Statement (CIS), filed on February 10, 1982 by the U.S. Department of Justice, p. 17.

Restrictions on the Divested Local Operating Companies

With respect to the proposed divestiture's substantive provisions, I must first express the State commissioners' grave concerns with its basic thrust: that AT&T is to spin off separate corporate entities which will be restricted to offering local exchange and exchange access services, and "natural monopoly service[s] actually regulated by tariff."[3/] AT&T would be permitted to retain the current BOCs' long-distance business (intrastate toll), along with AT&T's Long Lines Department, providing interstate services, its equipment manufacturing arm, Western Electric, and its research facilities, the Bell Laboratories. AT&T would also retain responsibility for sales and distribution of both plant and customer-provided equipment (CPE). In exchange for divesting itself of its local exchange operations, AT&T would be permitted for the first time to offer competitive telecommunications services such as data processing and other special information services.

On its face, this arrangement is an overbroad remedy for the purpose of preventing anticompetitive activity in the telecommunications industry, and as such, its implementation would put unnecessary and counterproductive limitations on the new local exchange carriers. These limitations would jeopardize the economic viability and, ultimately, the technological quality of the local companies, leading to substantial local rate increases and declining quality of local service.

The Justice Department contends that the divestiture plan as currently conceived is necessary to prevent AT&T from cross-subsidizing its competitive business with revenues derived from its regulated monopoly services. Another reason given for restricting the local carriers to the provision of exchange and exchange access services is to eliminate their incentive to discriminate against competitors of

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[3/] Proposed Modification, pp. 2 - 5 . Although the parties choose to refer to these separate corporate entities as "the BOCs" in the Proposed Modification, a designation also employed by the Justice Department in its CIS, the latter also notes that these entities need not correspond to the existing 22 BOCs which are wholly owned by AT&T. See CIS. p. 16, fn. 13. For the purpose of clarity, the separated local service entities are herein referred to as "local exchange carriers."

AT&T in the provision of interexchange services, information services, and in the provision of telecommunications equipment.[4/]

The cure proposed by the Justice Department for these barriers to competition, however, is in itself a formidable obstacle to a truly competitive telecommunications industry. By prohibiting the local carriers from providing anything but exchange and access services and regulated services, the divestiture plan would deny the local companies the opportunity to compete against the surviving AT&T. Thus, ironically, the proposed limitations on activities of the local carriers would tend to promote rather than avoid market dominance by AT&T in equipment and inter exchange services. We fail to see the logic of restricting the local exchange companies from continuing to offer those services with respect to which they have developed considerable expertise.

Even more important, particularly from the State regulator's point of view, is the effect of these business restrictions on the local companies' financial viability. Their restricted markets are likely to increase the cost of debt and equity capital for them, thereby contributing to local rate increases.

For these reasons, the NARUC intends to urge in its comments to the court that the divested portions of the BOCs should be permitted to offer competitive telecommunications services as well as regulated monopoly services. The BOCs should be spun off in their current corporate forms with all existing assets intact, and the newly independent companies (or some amalgam thereof) should be allowed to continue offering intrastate toll service and to compete in the equipment markets for both plant and CPE. Furthermore, the NARUC believes that other competitive and information services should be open to entry by the BOCs. This alternative would accomplish the goal of increasing competition in the telecommunications industry while assuring that the local companies

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[4/] CIS, p 26.

remain financially strong and capable of providing basic telephone service at affordable rates.

Asset Valuation and Transfers Under Proposed Divestiture

In the event that the court leaves intact the Proposed Modification's provisions which limit the local companies' permissible lines of business as previously described, the NARUC believes that a critical function will be State regulatory oversight over the valuation and transfer of any assets from the existing BOCs to AT&T or to any of the new local exchange carriers.

The Justice Department's CIS demonstrates some awareness of State regulatory jurisdiction over valuation issues. After describing the envisioned asset transfers under the divestiture, the CIS notes:

> Where assets to be transferred are presently included within the regulated rate base of a BOC, all questions of valuation are reserved to the appropriate regulatory agencies....[5]

This language does not adequately resolve questions concerning authority over asset valuation, however. It apparently concedes State utility commission jurisdiction *only* insofar as valuation of so-called "monopoly" equipment (i.e., the equipment and assets to be held by the new local exchange companies after divestiture) is concerned.

In fact, State commissions have jurisdiction over *all* of the current assets of the existing BOCs, including those to be *retained* by AT&T rather than "transferred" to the local exchange carriers. Any disposition of their respective assets, as well as the compensation received by the regulated carrier for the assets, must be approved by the appropriate State commissions. From the point of view of the local ratepayer, this difference is critical, since the Proposed Modification gives AT&T sole discretion

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[5] CIS, p. 20, fn. 16.

(with Justice Department oversight) for arriving at the terms of reorganization. Clearly it is in the surviving AT&T's economic interest to relegate as much of the cost burden of the divestiture as possible to the new local exchange carriers to be created under the plan.

State regulatory oversight is necessary to assure that all of the BOCs' dedicated assets--including CPE and interexchange facilities--are valued appropriately. This State role in the divestiture's implementation will serve to protect the interests of the local ratepayers, who are entitled to share in any gain generated from the disposition of dedicated assets. As it stands, the Proposed Modification is seriously deficient in its recognition of this role, and we intend to bring this problem to the attention of the court and the Justice Department.

Exchange Access Charges

As contemplated in the proposed modification and the CIS, after divestiture the new local exchange carriers will be required to provide AT&T and other long-distance carriers with equal access to the local exchange network, with compensation for such access to be set in tariffs filed by the local companies. These so-called access charges would replace the current division of revenues process under which AT&T reimburses the BOCs for interexchange services.

According to the CIS, the proposed consent decree modification mandates with respect to access charges only that the local companies levy charges which are differentiated for each element of access service, using a cost-based tariff structure that is nondiscriminatory in effect[6/] (CIS, pp. 35-36). This would not prevent, the CIS notes,

> appropriate regulatory or legislative authorities from requiring that the exchange access charges or any other mechanism prescribed by regulatory authorities be utilized as vehicles for payments to the BOCs of costs allocated to exchange access by jurisdictional separations or, in the case of apportionment between services subject to regulation by an individual State, by State regulatory authorities.[7/]

6/CIS, pp. 35-36.
7/Id., p. 36.

We are concerned that if the access charges fail to recover at minimum the same proportion of revenue for the local companies as that received through the existing division of revenues process, local rates may climb dramatically. Several factors could lead to such a result. The "cost-justified" restriction on access charges contained in the CIS could be used to mount a collateral attack upon the current separations process prescribed by the Federal Communications Commission in accordance with the recommendations of a Federal-State Joint Board.

Another potential limitation on access charges relates to technological and economic reality. As AT&T's Chairman Charles L. Brown recently confirmed in a discussion with NARUC members, if access charges are established at levels which recover adequate revenue for the local exchange companies but which make access to the local network "excessively" costly from the interexchange carriers' point of view, AT&T, other toll carriers, and large users will be induced to bypass the local network in favor of direct connection with intercity transmission systems. Such actions could divert significant amounts of revenue from the local exchange carriers.

Establishment of Exchange Area Boundaries

Another aspect of the divestiture plan that could result in steep local rate increases for some consumers is the establishment of exchange area boundaries. AT&T has been given discretion to devise exchange areas in accordance with criteria spelled out in the proposed modification, subject to Justice Department oversight, and court approval if an exchange area includes more than one standard metropolitan statistical area or crosses a State line.[8]

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[8] CIS, p. 30.

The NARUC considers this delegation of responsibility to AT&T a serious flaw in the divestiture proposal. State utility commissions have authority to configure exchange boundaries, and Justice Department oversight over AT&T's decisionmaking in this regard is a wholly inadequate substitute for the States' authority. The definition of exchange area boundaries is especially important to those in rural areas, since the boundaries will decree how much of their everyday telephone use is considered "long-distance" and how much is viewed as local calling.

The Proposed Modification should be altered to reflect the State commissions' authority over the establishment of exchange area boundaries. We will urge the court to do so prior to approving the divestiture.

Effect of Removing Yellow Pages and Embedded CPE From Local Exchange Companies

As stated earlier, the NARUC contends that the proposed divestiture would better serve the public interest if the existing BOCs are divested with all of their current assets intact. In any event, it is particularly important that the provision of directory advertising ("Yellow Pages") remain with the local carriers after divestiture. In addition, even if the court approves the proposed prohibition on the local exchange carriers' offering of customer premises equipment (CPE), embedded CPE should remain among the assets of the local companies.

The proposed divestiture would require AT&T to retain "those assets and contracts relating to the solicitation of Yellow Pages advertising and for its printing and delivery."[9] The Justice Department explains that the local exchange carriers, which would continue to provide "White Pages" or customer phone number and address lists, along with directory assistance services, will be able to generate revenues by granting "use-specific licenses" to AT&T and others who wish to compile and publish a Yellow Pages directory in conjunction with the alphabetical subscriber list. Consequently, it contends, the local exchange carriers

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[9] CIS, p. 29, fn. 24.

> "would have the ability to retain all of the above-competitive profits that presently are derived from the Yellow Pages, and, should regulators direct, apply this Yellow Pages income to reduce the cost of local telephone service."10/

The fundamental error in this analysis is the assumption that Yellow Pages services are competitive. In fact, Yellow Pages advertising has no direct competition. This powerful medium is used by subscribers as an adjunct to the white pages, and local ratepayers should continue to reap the benefits of such use on their telephone bill.

Even if the local exchange carriers were able, as the Justice Department asserts, to recoup some of their lost income by selling their White Pages lists, this arrangement would not begin to approach the current Yellow Pages contribution to the local companies' revenues.11/ Prohibiting the local companies from publishing the Yellow Pages would only ensure that a portion of the Yellow Pages revenues would be skimmed off before applying those revenues to the local companies' revenue requirements. This would result in detriment to local ratepayers--a detriment which is not offset in the least by any increase in competition.

Regarding embedded CPE, there is no competitive justification for requiring that AT&T retain those assets after the divestiture is implemented. The only effect of removing embedded CPE from the local exchange carriers would be another serious assault on the financial

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10/ CIS, p. 30, fn. 24.

11/ For a breakdown of States' use of directory advertising for telephone ratemaking purposes, see the Appendix.

posture of the local companies, making local rate increases necessary. In fact, AT&T's control of embedded CPE has a greater potential for anti-competitive impact than does retention of that equipment by divested local carriers.

Conclusion

In concluding my remarks, I wish to stress that State regulators support the encouragement of competition in the telecommunications industry where it is feasible and beneficial to the consumers as well as to the industry. The NARUC Executive Committee has endorsed, for example, those provisions of the Proposed Modification that would require the local carriers to provide equal access to competing interexchange carriers, as well as those provisions that guarantee non-discriminatory purchasing of equipment by the local companies.

But the public interest is not served by permitting a drastic revamping of regulated entities on the undemonstrated basis that the changes may prevent anticompetitive activity. Indeed, as the foregoing analysis has revealed, a number of revisions to the makeup of the local companies would actually limit competition.

The provision of universal basic telephone service at affordable rates remains as critical a policy-making and regulatory goal as ever, notwithstanding our appreciation of the value of a competitive marketplace in some aspects of the telecommunications industry. The members of the NARUC submit that this goal would be unnecessarily jeopardized under the present terms of the proposed AT&T divestiture. Accordingly, we urge the members of this Committee to bear our evaluation in mind as you examine for yourselves whether the purported objectives of the divestiture are sufficient to justify its potentially devastating impact on local telephone rates and service.

1. Does your Agency consider telephone directory advertising ("Yellow-Pages") revenues for ratemaking purposes? Yes ——. No. ——.

2. If "yes," how much net revenue (after taxes) was derived from directory advertising and applied in ratemaking: $ ——— from Bell System companies for the year ended ——, 19—? $——— from other telephone companies for the year ended ——, 19—?

3. If "yes," how much gross revenue (before taxes) would be necessary to replace the loss of directory advertising revenue for ratemaking purposes: $——— from all telephone companies for the year ended ———, 19—? $——— average per main station per month?

Example: In the State of North Carolina in 1980, Southern Bell Telephone Company's net revenues from directory advertising were $6.8 million while its gross revenues from this source were $14 million. With one million customers in North Carolina, the $14 million gross revenue requirement would have increased a subscriber's bill about $1.17 per month if the directory advertising revenue had not been applied in ratemaking.

USE OF TELEPHONE DIRECTORY ADVERTISING REVENUES IN STATE RATEMAKING

Name of agency	Considers directory advertising revenue for ratemaking	Net revenue derived from directory advertising and applied in ratemaking		Gross revenue necessary to replace loss of directory advertising revenue for ratemaking	Increase in subscriber's monthly bill if directory advertising revenue not applied in ratemaking	Fiscal year ended
		Bell System	Other telephone companies			
Alabama PSC	Yes			[5] $22,692,000	1.61	
Alaska PUC	Yes			[1] 4,000,000	5.50	Dec. 31, 1980.
Arizona CC	Yes	$26,410,000				
Arkansas PSC						
California PUC	Yes	121,600,000	[6] $41,400,000		1.25	Do.
Colorado PUC	Yes	12,175,000		[2] 23,668,000	1.59	Do.
Connecticut PUCA						
Delaware PSC	Yes	1,900,000		3,900,000	1.38	Do.
District of Columbia PSC	Yes	2,500,000		5,900,000	.71	Do.
Florida PSC	Yes	35,300,000	13,700,000	98,000,000	1.81	Do.
Georgia PSC						
Guam PUC						
Hawaii PUC	Yes		4,887,821	8,969,700	1.86	Do.
Idaho PUC	Yes					
Illinois CC	Yes	57,293,589			1.08	Do.
Indiana PSC	Yes	12,127,320			1.51	Do.
Iowa SCC	Yes	11,556,761		[5] 23,231,501	2.04	Do.
Kansas SCC	Yes	9,666,000	197,000	[3] 20,135,000	2.01	June 30, 1981.
Kentucky PSC	Yes	4,389,447	1,620,922	11,840,756	.75	Dec. 31, 1980.
Louisiana PSC	Yes	9,913,820	419,572	37,906,085	1.86	Do.
Maine PUC						
Maryland PSC	Yes	14,250,795		30,713,042	1.46	Do.
Massachusetts DPU						
Michigan PSC	Yes	37,528,927	2,431,845	74,001,430	1.73	Do.
Minnesota PUC	Yes					
Mississippi PSC	Yes					
Missouri PSC	Yes			63,938,578	2.51	Dec. 12, 1980.
Montana PSC	Yes	1,450,000		2,940,000	.92	June 30, 1980.
Nebraska PSC	Yes					
Nevada PSC	Yes			21,015,746		Dec. 31, 1980.
New Hampshire PUC						
New Jersey BPU	Yes	27,200,000		52,700,000	1.35	Do.
New Mexico SCC	No [4]					
New York PSC	Yes	32,000,000	3,200,000	65,000,000	.75	Do.
North Carolina UC	Yes	7,528,746	7,500,000	31,000,000	1.14	May 31, 1981.
North Dakota PSC	Yes	2,719,124	906,812	6,351,690	1.93	Dec. 31, 1980.
Ohio PUC	No					
Oklahoma CC						
Oregon PUC	Yes	20,574,000	4,869,000	38,041,000	2.81	Do.
Pennsylvania PUC	Yes					

USE OF TELEPHONE DIRECTORY ADVERTISING REVENUES IN STATE RATEMAKING—Continued

Name of agency	Considers directory advertising revenue for ratemaking	Net revenue derived from directory advertising and applied in ratemaking		Gross revenue necessary to replace loss of directory advertising revenue for ratemaking	Increase in subscriber's monthly bill if directory advertising revenue not applied in ratemaking	Fiscal year ended
		Bell System	Other telephone companies			
Puerto Rico PSC						Dec. 31, 1980.
Rhode Island PUC	Yes					
South Carolina PSC	Yes	$3,736,782		[5] $7,473,564	.77	Do.
South Dakota PUC						
Tennessee PSC	Yes			21,057,476	1.08	Do.
Texas PUC	Yes	77,026,680	$6,436,460	155,353,158	1.97	Do.
Utah PSC						
Vermont PSB						
Virgin Islands PSC	No					
Virginia SCC	Yes	10,125,000		[5] 19,463,000	1.00	Aug. 31, 1981.
Washington UTC	Yes	18,855,000	3,653,000	43,638,000	2.06	Dec. 31, 1980.
West Virginia PSC						
Wisconsin PSC	Yes	11,200,000	5,200,000	37,500,000	1.56	Do.
Wyoming PSC	Yes	1,013,000		[5] 1,013,000	.47	Do.

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[1] Anchorage Telephone Utility (municipal) represents at least 50 percent of all gross revenues.

[2] Applies only to Mountain Bell intrastate.

[3] Figures derived from rate cases of Southwestern Bell Telephone Co. and United Telephone Co. of Kansas which supplies approximately 20 percent of independent main stations.

[4] However, New Mexico SCC is seeking constitutional amendment to permit consideration of directory advertising revenue for ratemaking purposes. The net revenue derived from directory advertising by Mountain Bell is $7,029,000, and the net revenue derived from such advertising by the three largest independents (Continental, General Tel. of S.W. and Navaho) is $791,718.

[5] Bell System only.

[6] General Telephone of California only.

Senator SPECTER. Mr. Brickman, your prepared statement will be made a part of the record. We would very much appreciate it if you would summarize it. With the time constraints which we have, we would appreciate your being brief, please.

STATEMENT OF ROBERT BRICKMAN, ASSISTANT ATTORNEY GENERAL, ANTITRUST DIVISION, STATE OF ARIZONA

Mr. BRICKMAN. Mr. Chairman, first of all, I feel like I am the calm after the storm. I disagree with most of what has been said, but agree with a little bit of it.

Second, I am here on behalf of the Arizona attorney general. We represent the antitrust interests of the State and the public utility commission of that State. From what I have heard today, the views of our public utility commission differ significantly from those views expressed by NARUC.

As to the issues, first, what will the impact of the decree be on the local rates? Arizona feels, as do many States, that, given an active State role in the consent decree proceedings, that local rates indeed could go down.

Second of all, as to the question of whether there is an immediate need for legislation, Arizona and a good number of States who are in town this week engaged in working sessions on the consent decree impact believe that any legislation at this point in time is premature.

I could go on for hours with all of the reasons why.

Senator SPECTER. That is a good place to start. What is your evidentiary basis for your thought that rates could go down?

Mr. **Brickman**. First of all, we do have concerns, as set forth in our statement, with the decree as it presently is written and envisioned. However, we view the decree as a challenge under which the Justice Department, AT&T, and all of the regulatory agencies—that is the FCC and 50 State public utility commissions—can get together and try to work within the consent decree proceedings to come up with a better solution to some of the problems.

Senator **Specter**. Under what conceivable arrangement can you postulate rates going down?

Mr. **Brickman**. If we come up with a very, very healthy BOC, if the States are allowed to assume their regulatory authority to set access charges both for interstate and intrastate services, and if the States have a role in the spinning off of the BOC's and the transfer of assets, we believe that you might see a competitive environment and a stabilization, and perhaps a lowering, of rates for local telephone services.

Senator **Specter**. Notwithstanding the problems of inflation and depreciation schedules and 1-year expensing?

Mr. **Brickman**. A lot of those problems—and I agree with the chairman—have been created by the FCC. The States, regardless of whether they have been sleeping for years before this point, now are very active and very concerned. I think you will see many States coming up with scenarios that might make for a better world of telecommunications for the industry and for consumers.

Senator **Specter**. Which States are you working with that you referred to a few moments ago?

Mr. **Brickman**. I have been working with approximately 30 States for the last 3 months. We are in town this week for working sessions, and we are discussing our joint Tunney Act comments.

Senator **Specter**. You do propose to submit those comments to Judge Greene?

Mr. **Brickman**. Yes, we do.

Senator **Specter**. Would you submit them to the committee as well? If you have a postulate which could lead to the lowering of rates, I think that we would all be very much interested to see the specifics.

Mr. **Brickman**. We would be pleased to do so, Mr. Chairman.

[Prepared statement of Robert Brickman follows:]

TESTIMONY OF THE STATE OF ARIZONA BEFORE THE U.S. SENATE COMMITTEE ON THE JUDICIARY ON THE IMPACT OF THE 1982 AT&T CONSENT DECREE ON CONSUMERS

Mr. Chairman and members of the Senate Judiciary Committee, my name is Robert Brickman. I am an Assistant Attorney General for the State of Arizona. I am testifying today on behalf of the Attorney General and the Arizona Corporation Commission, the State's constitutionally-established public utility commission. Thank you for the opportunity to share with the Committee our concerns over the impact of the proposed Consent Decree between the Department of Justice (Justice) and AT&T on consumers.

INTRODUCTION

The State of Arizona supports the efforts by Justice and AT&T to resolve their antitrust lawsuit by means of the proposed Consent Decree. We believe that the Consent Decree provisions may provide for removing barriers to effective competition in the telecommunications industry, and still preserve the national public policy of providing universal telephone service at affordable rates.

Our basic conclusion is that the Decree has merit; however, in order for the Decree to achieve success it will require close coordination and cooperation by Justice with the various states who are charged under current law with regulating telephone service which will be impacted by the Decree. In addition, the Decree will require clarification of certain terms and procedures.

We believe that it is necessary for the states to play an essential role in the formulation and implementation of the divestiture and restructuring process, including BOC asset valuation and capitalization, exchange boundaries and exchange access charges. In this way, the states can assure that the resulting BOC's will be able to provide quality phone service at reasonable rates.

Finally, we believe that the states, in partnership with the parties to the lawsuit and the Federal Communications Commission, can effectively resolve any problems and fashion a workable plan for the divestiture and restructuring of the telecommunications industry which may be superior to the results which may be obtained pursuant to other Federal initiatives either before the Commission or the Congress.

GENERAL CONCERNS WITH PROPOSED DECREE

Our overriding concern with the Decree is that it may adversely affect the quality and the cost of basic telephone service within the state. While we applaud the efforts of Justice to bring about structural changes to what has basically been a regulated and monopolistic environment, the Decree stems from an antitrust foundation and not a public interest standard embodied in the Communications Act of 1934 and state statutes, including those of Arizona.

Unlike the other Federal initiatives, the Decree attempts to inject competition by changing the structure of the basic telephone industry and imposing constraints on the future operations of the local telephone companies.

What Justice has attempted to do is to divide the telecommunications industry into two separate parts: The regulated, or natural monopoly portion, and the unregulated or competitive portion. Conceptually, any portion of the telecommunications industry which currently is capable of competition, or potentially capable of competition, should be deregulated; whereas, any portion of the industry where competition simply will not work should be given natural monopoly status and be regulated by the appropriate jurisdictional body.

Implementing this approach, Justice proposes, and AT&T agrees, to sever from AT&T the source of its monopoly power:

the local telephone operating companies. The local telephone companies will be restricted to providing local telephone service and access to its system and customers by any company wishing to provide telecommunications or information services. AT&T, on the other hand, would keep its other subsidiaries, Long Lines division, Bell Laboratories and Western Electric and would be free to enter into any competitive telecommunications services.

More specifically, under the Decree decisions are made as to which products are competitive and which products are not. Additionally, the Decree will establish a new system of local exchange areas, and require a new system of exchange access charges; the Decree goes far beyond legislative and FCC attempts to provide a mechanism to allow AT&T to compete in manufacturing, supplying customer premises equipment and offering information services; and the Decree is limited to twenty-two of AT&T's operating companies. It will not affect any of the 1,500 independent telephone companies nor would it affect Cincinnati Bell and Southern New England Bell in which AT&T only has a minority interest.

Therefore, absent any changes in federal regulation, the Decree imposes a separate system of regulation exclusively for the Bell system. Finally, because the Decree does not change current regulatory authority nor does it bind other than AT&T and the Department of Justice, there are serious concerns raised as to how the various regulatory bodies will treat the changes proposed by the Decree.

SPECIFIC CONCERNS WITH PROVISIONS IN PROPOSED DECREE

What follows is the list of our specific concerns with the Decree. These concerns, which are regulatory, financial and technical/operational, relate to whether the form of divestiture proposed in the Decree is in the public interest as it relates to the State of Arizona. Many of the problems enumerated below could be dealt with by amending the Decree itself. In addition, as the Decree process unfolds, there may be a necessity for federal or state legislation to establish or preserve important public interest policies.

1. PREEMPTION

Despite the fact that the language in the Decree would appear to preempt inconsistent state statutes, Justice contends that the Decree is not intended to alter any present regulatory jurisdiction, be it state or federal. Nevertheless, there is a significant amount of uncertainty and ambiguity as to how the structural changes proposed by the Decree will be implemented and who will be charged with overseeing said changes. There is a need for certainty as to the states' role under the Decree.

Despite the preemption problems posed by the Decree, the states at least have an opportunity to preserve their present regulatory authority and may, in fact, be able to expand their authority since the telecommunications industry will become more state-oriented, as opposed to nationwide oriented. By contrast, the legislative and FCC approaches would preempt current state regulatory authority. Therefore, it may be advantageous for us to work out our preemption problems within the context of the Decree.

2. DIVESTITURE OF THE BELL OPERATING COMPANIES

Perhaps the most significant problem created by the Decree is what the to-be-divested bell operating companies will look like. There are no guidelines for determining the financial condition of a BOC upon divestiture and no provision for BOC or regulatory input in the reorganization planning process. Further, no mechanism is specified or referenced in establishing the value of assets to be transferred from BOC's to AT&T.

While several proposals have been offered on how to accomplish this process, there is general agreement of behalf of the states that they should have a role in this process within the context of the Decree. Having a role here would be a significant achievement since the individual states have no role to play with respect to the FCC and legislative approaches. There, determinations will be made by Federal/State joint boards comprised of two to three FCC Commissioners and two to three state public utility commissioners. Current joint board operations do not take into account regional variations in the delivery of telephone services and tend to contain certain public policy objectives which the states may or may not agree with. For example, the FCC has promoted competition in long distance telephone services by establishing procedures which have kept access costs low. Many people believe that this has resulted in rates which are significantly lower than they otherwise would be to the detriment of consumers of local telephone service who have been forced to pay higher rates. Therefore, it is essential that the states play a major role in this area; otherwise, we run the risk of being overwhelmed in the name of promoting competition.

3. EXCHANGE ACCESS

Under the Decree, the BOC's must provide access to its exchange facilities to all companies offering competitive telecommunications services directly to consumers. The Decree is unclear on what methodology the parties will use to arrive at a system of access charges and what governmental entity will establish access charges.

In this connection, once the BOC's are divested from AT&T, they will no longer be common carriers (interstate telephone companies) and therefore, will be subject to limited FCC jurisdiction. Since access to an exchange basically is the same whether access is being sought by a company inside the state or by a company located outside the state, we believe that the state should be responsible for the setting of exchange access rates for interstate and intrastate business.

4. EXCHANGE BOUNDARIES

Under the Decree, the parties will establish the divisions within each state for exchange areas. That is, the parties will decide the geographical boundaries of each and every local telephone exchange area. In so doing, the parties will determine which phone calls will be local or intraexchange, and which phone calls will be long distance, or interexchange. This will impact the cost or charges for providing local exchange service, the cost charged for exchange access, and which types of telephone equipment the BOC must have in order to provide service within the exchange area and provide access to its exchange facilities.

Again, the states must also be involved in this process since there are many regional and geographic variations among the states. For example, Arizona has a unique make-up of both high-density and low-density areas.

5. BY-PASS ISSUES

The Decree is quite specific on what activities the BOC's may engage in after divestiture. However, the Decree is silent on what activities AT&T may engage in which duplicate or compete with services to be provided by the BOC's. AT&T is free to establish its own system of providing business customers with local exchange telephone services by means of microwave or cellular technology which avoids the use of the BOC's facilities. Not only would such activities by AT&T affect the financial viability of the BOC, they might result in non-business consumers having to pay higher rates for their local telephone services which are provided only by the BOC.

6. VIABILITY OF THE LOCAL BOC's and IMPACT ON LOCAL EXCHANGE RATES

Restrictions on the operations of the BOC's will remove a number of very profitable activities, including yellow pages advertising, and the sales and rentals of customer telephone equipment. These profitable services have enabled the BOC's to keep local telephone rates lower than they might otherwise be.

Of particular interest to Arizona is the provision in the Decree that allows the BOC to offer telephone equipment only for emergency services. This emergency exception is much too limited since it would exclude the ability of Mountain Bell to provide enhanced 911 emergency services, telephone equipment for the deaf, and lifeline telephone equipment for the poor and elderly.

7. PRE-DIVESTITURE/DIVESTITURE

The Decree is silent on whether prior to its entry or approval of the divestiture plan AT&T can divest itself of local exchange assets. The problems posed by such activity directly relate to the condition of the divested BOC under the Decree since much of the equipment necessary to keep it financially viable may previously have been sold by AT&T; and the regulated BOC may face competition from an unregulated and stronger (since it purchased the BOC's former assets) independent telephone company.

8. DIRECTORY ADVERTISING

While the Decree does not specifically address directory operations, Justice contends that basic directory operation and the white pages should remain with the BOC; however, yellow page operation or advertising operations should go to AT&T after the divestiture. The overall directory operation is extremely profitable, with most of the profits coming from the sale of yellow pages advertisements. Loss of these directory profits through divestiture would require offsetting local service rate increases.

9. RESEARCH AND DEVELOPMENT AND OTHER CONTRACT SERVICES

The Decree will terminate the various contracts between AT&T and the BOC's under which the BOC's have paid AT&T for advice and assistance from AT&T's General Department, and for basic research and systems engineering work performed by Bell

Laboratories, the research arm of the Bell System. We are concerned that there is no provision in the Decree for reimbursing to the BOC's or to local telephone service consumers for the development of telephone exchange and non-exchange related projects and innovations.

10. WESTERN ELECTRIC

Presently, Mountain Bell is dependent upon Western Electric, the manufacturing arm of the Bell system, for millions of dollars in equipment and services each year. Under the Decree, the contracts which make Mountain Bell a captive purchaser or customer of Western Electric will be terminated. However, in the short run there will be few if any competitors. Therefore, competitive pressures will not prevent Western Electric from increasing its prices.

Under current regulation, regulators can prevent supracompetitive price increases by refusing to pass them on to the rate payers. After divestiture, however, this profit limiting mechanism will disappear.

11. SOVEREIGN NATIONS

Arizona, and a select number of other states, may have the additional problem of the impact of the Decree on the present operations of telephone companies either owned by Indian tribes or located on Indian reservations because of the tribes' status as a sovereign nation.

12. TRANSITION PERIODS

Unlike the various federal approaches, the Decree does not provide for any transition period from a regulated environment to an unregulated environment for telephone equipment, including customer premises equipment, yellow pages, etc. Such an abrupt change and loss of revenues to the BOC's in the short run may have a serious impact not only on the financial viability of the BOC, but on the affordability of basic telephone service by consumers.

RECOMMENDATIONS

Arizona recommends that this Committee, as well as the Congress in general, closely monitor the Consent Decree proceedings as they unfold. We urge you to undertake this role and exercise legislative restraint until it appears necessary to intervene in order to protect the marketplace and guarantee to consumers throughout this Country quality phone service at reasonable rates.

What is at stake here is the establishment of the blueprint for the telecommunications industry for at least the next decade. Also at stake here is the establishment of the regulatory framework to govern the telecommunications industry for at least the next decade. Finally, what is at stake here is an experiment in Federalism and government/business cooperation.

We believe that the states, the FCC, Justice, AT&T and actual or potential competitors in the telecommunications industry have a unique opportunity to collectively work together before a neutral public interest magistrate, Judge Greene, in fashioning and implementing a workable plan for the divestiture and restructuring of the telecommunications industry. Arizona believes that the Congress should allow these parties a chance to succeed. And we urge the Congress to carefully consider any legislative efforts which might conflict, alter, or affect the implementation of the provisions under the Consent Decree; and we respectfully request that any such legislative efforts come only when it clearly becomes apparent that the parties no longer can work within the context of the Decree process and still safeguard for the consumer quality phone service at reasonable rates.

CONCLUSION

We believe that we have identified a very substantial number of important concerns--regulatory, financial and technical/operational--which relate to whether the divestiture and other proposed provisions in the Decree are in the public interest and the best interests of the State and its consumers.

We believe that the Decree process should be given a chance to work. If the Decree is ultimately found to be in the public interest by the District Court, many of the concerns and problems enumerated in the analysis can and should be dealt with in the Decree itself. The Congress should closely monitor the Decree process and consider legislation only if absolutely necessary to establish or preserve important public interest policies--such as maintenance of universal telephone service at affordable rates, and the legitimate regulatory role of the states.

Arizona shares the concerns of this Committee over the potential impact of the Decree on consumers. We remain committed to work with the Congress and within the Decree process to protect the State and its consumers from any adverse or disruptive results, including any escalation in the cost for local telephone service.

Senator SPECTER. Thank you very much, Mr. Brickman.

Our final witness is Mr. John W. Wilson, economic counsel of J. W. Wilson & Associates, Inc. Mr. Wilson, we have your full statement. It will be made part of the record. We would appreciate a brief summary in view of the time constraints. We will then see what questions evolve. Thank you for coming.

Mr. WILSON. I would be glad to do that, Mr. Chairman, thank you.

Senator SPECTER. Without objection, your statement will be inserted.

STATEMENT OF JOHN W. WILSON, J. W. WILSON & ASSOCIATES, INC., WASHINGTON, D.C.

Mr. WILSON. Mr. Chairman, as my prepared statement indicates, our firm does work for a number of State regulatory commissions. I am not appearing here on their behalf or in any official capacity this morning. I am appearing here at the request of the committee as an independent expert in the field.

I have three points that I would like to make. The first is that the divestiture is tremendously in the public interest. It is critically needed. The Bell System, AT&T and its subsidiaries, the Bell operating companies, have had a stranglehold on competition in both terminal equipment and transmission services for more than a decade that State regulators and Federal regulators have not been able to deal with effectively. If this situation is not corrected, which the divestiture will correct, the long-term consequences for this Nation in terms of its communications technology will be very bad. In terms of where this economy should be going and in terms of the potential for advancement and development in electronics and telecommunications, this divestiture is one of the most important public acts that has been undertaken by any Government agency in many decades.

There are some things that have to be ironed out. The process is working. I believe the wrinkles that need ironing out will be taken care of through the antitrust process that is functioning appropriately, functioning the way that Congress intended it to when it enacted antitrust legislation and reenforced antitrust initiatives over the years.

The second point I want to make is that there is absolutely no foundation in fact for the conclusion that local exchange rates will have to go up as a result of the divestiture. The conclusion that local exchange rates will have to go up derives entirely from absolutely absurd cost allocation techniques that the Bell System has employed over the years. These have been submitted in embedded direct cost analyses to State regulatory commissions. In these studies Bell simply loads all of the common costs of subscriber loops, nontraffic sensitive central office switching equipment and other types of investments and costs onto local exchange service.

If cost studies are done appropriately—and State regulators know how to do them because they deal with joint costs in terms of electric utilities, water utilities, and gas pipelines all the time—local exchange rates should decline. Now, that is a statement that I make independent of the impacts of inflation. Obviously, nobody can effectively predict over the next 5 years whether the inflation rate is going to be 5 percent or 15 percent. But, in terms of where we stand right now, local exchange rates are paying more than their fair share of costs.

I have submitted, along with my testimony, cost studies that we have completed for three jurisdictions: West Virginia, which is a rural, poor State; the State of Maryland, which is quite urban, has a diverse geography and really a diverse type of economy; and Washington, D.C., which is entirely urban. In all three of these instances, it is seen that local exchange rates are paying more than their fair share. The services that are being subsidized are the competitive services. It is customer premises equipment and private line services that are being subsidized both by local exchange and by interstate toll.

The third point that I want to make is that there are tremendous differences between jurisdictions in the United States. To give you an example, in Washington, D.C., 40 percent of all of the telephones in this town are centrex telephones. That means that the local loop and the central office equipment are being used to a substantial degree for intercom services between desks in adjoining offices. They are not being used for traditional types of telephone calls, either local exchange or toll.

This differs dramatically with circumstances in States like Vermont or Arizona or New Mexico or South Dakota, where centrex does not carry anywhere near that percentage of the investment base of the telephone company. The States differ tremendously in terms of what competition will do for them immediately, also. Long-distance transmission competition benefits will accrue most immediately to the populous States that have very attractive looking markets for competitors to enter. The benefits of that type of competition are further down the road for less populous States.

The bottom line of this is that subsequent to the divestiture the determination of local costs, the joint costs of loops, the joint costs of central office switching equipment, other types of costs that the telephone companies incur, including labor costs that are related to these functions, should be made a matter of local determination. It is the State commissions that have the capability and have the talent and have the experience in dealing with joint costs. They have dealt with it for decades in terms of electric utilities. The FCC is not capable of carrying that task on.

If there is one point I want to stress more than any other, it is the point that, if the job is done properly, there is no question that local exchange rates will be contained and can actually decline because local exchange ratepayers are paying more than their fair share now.

If the job is done improperly, there is no question that the result can be rigged so that the local exchange ratepayer bears the burden of the costs of competitive services. That has been part of the problem up until now.

Senator SPECTER. When you say that the divestiture is conclusively in the public interest, does that depend at all on the contours of the settlement which is approved by Judge Greene?

Mr. WILSON. The contours of the settlement approved by Judge Greene can make it an excellent solution or a suboptimal solution.

Senator SPECTER. There is nothing he can do that would make it less than desirable?

Mr. WILSON. There is nothing he can do that can make it worse than going back to the situation that existed before the Justice Department brought the suit.

Senator SPECTER. Will you have any role in submitting any information as to Judge Greene?

Mr. WILSON. The eight States that I mention in my testimony have retained our firm for the purpose of helping to prepare those comments, yes. We would be glad to submit them to you as well.

Senator SPECTER. Mr. Wilson, we very much appreciate your coming this morning.

I am advised by staff that we did not receive your statement until this morning. We would like an opportunity to submit some questions to you if you would be willing to receive them and respond to them.

Mr. WILSON. I would be more than glad to, yes, sir.

Senator SPECTER. Without objection, the material will be inserted into the record.

[Material referred to follows:]

Testimony of Dr. John W. Wilson

I would like to thank the Chairman and Members of this Committee for the honor that you have extended by inviting me to appear before you today to present testimony on what I consider to be one of the most important economic matters now pending in our nation -- the competitive restructuring of our communications industry.

While my appearance today is on a personal basis and not on behalf of any client, it should be noted that my firm is retained on matters pertaining to AT&T's reorganization by the States of Idaho, Iowa, Montana, Nebraska, New Mexico, South Dakota, Utah and Wyoming. We are also retained by the North American Telephone Association and we have worked with regulatory authorities in various other states on related telephone utility matters.

The proposed antitrust settlement that is now pending before Judge Greene in the District Court and related legislative initiatives in the Senate and House will determine the potential for competitive performance and public service in communications markets for many years to come. In particular, the ultimate determination of how all of the Bell System's joint switching and access costs are to be divided between local exchange, toll and other services will determine whether the pending AT&T reorganization serves the public's interest in achieving better competitive communications services or whether these apparently well-meaning efforts degenerate into new structural arrangements to cross subsidize Bell's competitive enterprises at the expense of local exchange telephone ratepayers throughout the country.

It has been suggested that a reduction in interstate settlement payments resulting from the future assignment of competitive equipment to a new AT&T subsidiary will force dramatic increases in local exchange service charges. That contention, however, rests on AT&T's cost allocation method, and because that method is improper the implied result does not follow.

Telephone rates have seldom been designed to track costs to the extent that is usually required for other utilities. Rather, value-of-service pricing and cross subsidies have been commonly accepted features in the industry. Cost-of-service studies of the type generally required for other utilities have never been the cornerstone of telephone ratemaking in any jurisdiction.

As the emphasis on competition and deregulation has enlarged the importance of cost-based telephone rates, telephone regulators have been inundated with increasingly dire warnings from that competition and the AT&T antitrust settlement will serve to increase local exchange rates which, up to now, have allegedly been subsidized by toll and terminal equipment revenues.

Quite naturally, regulators and legislators, concerned about their responsibilities to protect utility ratepayers from excessive rate increases while, at the same time, providing for public access to adequate telephone service, have been greatly concerned about the possibility of substantially higher telephone rates. In this context, AT&T's proposed reduction of separations settlement payments to intrastate service made claims that local exchange access charges could more than double seem plausible. Moreover, in addition to the threat of greatly increased local access charges, the prospect of additional separate charges for measured service, terminal equipment and wiring (all of which were previously included in the bundled access charge) made the scenario seem all the more bleak.

The thought of a local exchange service subscriber, who had been paying, say, a flat rate of $10.00 per month for service on a "bundled" basis, now being asked to pay $20.00 to $30.00 for exchange access plus measured usage charges of $5.00 to $20.00 plus $40.00 or $50.00 for a telephone and an additional charge for inside wiring was difficult to digest -- to say the least. But that scenario is contrived because AT&T's underlying assumptions are not correct. For example, Bell's underpricing of competitive terminal equipment and private line services at the operating company level has been greater than the terminal equipment portion of interstate settlement payments to local companies. Consequently, CPE deregulation should impose no burden on local ratepayers. Moreover, AT&T has grossly overstated the costs of local exchange service by allocating all joint access costs to local exchange when, in fact, these costs are incurred for the benefit of interstate toll services as well. Thus, the fate of local exchange ratepayers in a new competitive environment can be much less intimidating than some scenarios suggest. Indeed, the proper attribution of total system costs and the consequent removal of cross subsidies that favor competitive service offerings should result in a decline in local exchange service subscriber's rates. This is true even in the context of AT&T's contemplated reorganization, if plant and joint costs are distributed properly between AT&T and the operating companies. Of course, the transfer price of assets will be critical in that regard, and if AT&T walks off with an understated portion of total system costs, then local rates will have to rise and Bell's competitive subsidies will be perpetuated. But that will be a consequence of the ultimate plant and cost allocations, not deregulation or reorganization. In order to resolve this central issue fairly, properly structured cost studies must replace AT&T's highly discretionary approach to ratemaking under which local exchange users pay for all costs that are not covered by toll, terminal equipment, private line and other vertical service revenues.

This traditional Bell System pricing approach is not only antithetical to sound cost responsibility determinations, it also undermines effective competition throughout our economy. In our market economy, it is the price system which allocates resources, encourages producer and consumer efficiency, rations limited supplies of goods and services and, in general, serves as a disciplinary force in determining what is produced, in what volume, and how it is distributed. The prices of various goods and services in our economy constitute a ranking of incentives affecting both producers and consumers. By their willingness to pay various prices for goods, consumers signal their preferences to producers. By their willingness to sell various goods at different prices, producers, in turn, signal costs to consumers. When competitive conditions are present, the price system forces each individual producer and consumer, while working purely in his own interest, to contribute to the welfare of society as a whole. Under these conditions, available resources are used in the most efficient way to produce the largest possible quantity of the most wanted goods and services, and these are distributed so as to maximize aggregate economic satisfaction.

In competitive markets, prices tend to reach an equilibrium level which covers the total costs of production (including a fair return to capital investment). Prices above such a level cannot prevail over long periods, as that encourages expanded production which, in turn, drives prices down. At the same time, high prices constrain consumption. Conversely, prices below cost encourage consumption and discourage production, as no firm can exist for long when price fails to cover the costs of production. Thus, in competitive markets, consumers can not really expect to buy goods at prices below the cost of production, and they can not be forced for long to pay prices above a level that covers production costs and a fair return.

Unfortunately, the characteristics of competition are not present with respect to the provision of local exchange telephone service. At that level, in the interest of technical efficiency, we permit single entities, such as a Bell operating company, to function as a monopoly within a defined service area, subject to rate control by regulatory authorities. In this way, to some degree, the discipline of the market is simulated through the regulation of utility rates. But, if this regulated sector is to function in the public interest, the structure of rates charged must present essentially the same system of cost-reflective incentives to consumers as those rates which would prevail in a competitive market.

Consequently, and in contrast to the Joint Board's recent forelorn assertion that "it is well known that there are no objectively verifiable cost causative realities involved in the allocation of nontraffic sensitive joint and common costs", a full and accurate cost allocation is essential so that the adequacy of rates and charges for local exchange service can, indeed, be evaluated objectively.

One of the foremost goals of regulation is to ensure that rates are equitable and reasonable. Sound, cost studies are necessary to accomplish this goal. Because most telephone companies provide different products in distinctly different market environments, all joint and common costs must be examined and properly allocated to the various services which they support.

Along with my prepared statement today, I am providing the summary results of several cost studies that we have completed recently pertaining to AT&T's local affiliates, Chesapeake and Potomac Telephone Company of Maryland, West Virginia and the District of Columbia.

In performing these cost studies, actual Bell System Operating Company investments, costs and revenues for 1980 were utilized. The volume of services that were actually provided in 1980 and the usage and availability of facilities for those services were also used. In distributing costs between categories, direct costs were identified and assigned to particular service categories. Common and joint costs were allocated to service categories according to functions such as the use of facilities, availability of facilities, and the design and performance characteristics of facilities.

To develop these cost-of-service studies, all of the cost and rate base accounts which determined the Bell operating companies total revenue requirements in 1980 were first functionalized. Each individual cost and rate base component was then assigned or allocated to the appropriate service category in accordance with these cost-of-service functionalizations and category cost responsibilities.

Many costs can, in fact, be directly assigned to specific cost categories. For example, wide band (8F) central office circuit equipment costs are directly assigned to private line, and local message exchange trunk investments (8KCT-1) and short haul dial tandem (2B) costs are directly assigned to local exchange service as are the maintenance and depreciation costs of this equipment. Other costs, such as loop or switching costs, which are incurred to provide service to several different categories, must, of course, first be functionalized in order to make proper category cost allocations.

Since the AT&T operating companies incur costs in relation to several identifiable service functions such as:

- Service availability
- Service over distance
- Service over time, and
- Service connections,

these all must be accounted for in the cost allocation process. For example, ESS central office switches are available to provide local exchange switching, state and interstate toll switching, Centrex and custom calling services. Likewise, a subscriber's loop may be used alternatively for state toll, exchange and interexchange service. In turn, a proper allocation of loop costs must take availability, distance, time and number of connections into account since each of these functions is related to the cost of subscriber loops. Quantifiable measures such as dial equipment minutes, message minute miles and number of calls, as well as availability must therefore be used to allocate AT&T's functionalized cost and rate base accounts on a fully distributed basis.

In addition, other specific allocators were used in the studies. For example, traffic units, which are measurements taken on various types of equipment that represent the use or occupancy of that type of equipment (e.g., operator work times), were used where available. Also, dial equipment minutes, number of circuit miles, number of messages, operator handled messages, and plant availability, were used where appropriate. In addition, certain expense categories (e.g., depreciation and maintenance) can be allocated based on investment, and other expenses (e.g., pensions and social security taxes) can be allocated based on salary and wage costs.

Complex allocators, such as message minute miles, permit the incorporation of multiple economic functions such as minutes of use and mileage as cost factors where the design and use of telephone plant warrants such an approach.

The most important result of the studies is that they show local exchange rates to clearly exceed the full costs of providing local exchange service. This is, obviously, a very important conclusion because it demonstrates that local exchange ratepayers are not being subsidized by toll or CPE service revenues.

In fact, local exchange ratepayers in 1980 carried a part of AT&T's costs which should actually have been collected through terminal equipment and private line rates. These other rates, in turn, were below the cost-of-service for their respective categories.

Because local exchange revenues exceed the fully distributed costs of local exchange service, no increases in local exchange rates are warranted as a result of CPE deregulation or AT&T reorganization. Rather, because certain competitive services, such as CPE and private line, have been priced on a noncompensatory basis, the removal of these competitive services and their associated costs from the remaining regulated telephone utility business should enable state regulators to institute rate reductions for local exchange service.

Of course, if Bell's full costs are not properly distributed among all the categories of service which cause them to be incurred, then the currently excessive nature of local exchange rates could be concealed and perpetuated. In fact, without attention to complete cost-of-service evidence of this type, one could improperly conclude that local exchange rates are not cost compensatory and that the deregulation of terminal equipment, private line, and other competitive services will trigger a need for local exchange rate increases.

The results of these studies differ dramatically from those that have been suggested previously by AT&T. The principal reason is that, in its own cost studies, AT&T directly assigns only a portion of its total costs to service categories, and then attributes the remainder including all common access costs to local exchange service. This, of course, is improper because the local exchange service category should be assigned only a portion of access costs. State toll, interstate toll, Centrex and certain other vertical services all require exchange access, and therefore access costs should be allocated among all of these service categories. Because AT&T does not follow this approach, however, useful conclusions about revenue adequacy by service class can not be drawn from AT&T's own cost studies.

The assignment of joint and common plant investments and expenses between local operating company services and the enterprises divested to AT&T is likely to be the single most critical issue in considering the merits of AT&T's divestiture plan. This is true both from a consumer impact perspective and in terms of antitrust policy. Obviously, the settlement will not promote competition if the implementation plan provides for cross subsidies to Bell's competitive businesses.

It should be emphasized that the proper cost allocation between local exchange and other telephone services, if done properly, is not likely to be uniform for all states. For example, in 1980 the toll percentage of total calls ranged from as low as 6 percent in some states to more than 20 percent in others. Likewise, 40 percent of the telephones in the District of Columbia are Centrex lines, and this also varies dramatically in other jurisdictions. Thus, a proper allocation of joint and common costs for each jurisdiction can not be achieved on the basis of average nationwide ratios.

Although the treatment of liabilities has received far less attention in recent weeks than the treatment of assets, valuations and allocations pertaining to the right hand side of the balance sheet are at least as important as those pertaining to assets. If AT&T's still unveiled divestiture plan is to split the liability side of the balance sheet in some pro rata manner between exchange and non-exchange entities, that, like an improper asset allocation, would produce large over charges to local exchange ratepayers. Elementary financial principles show that local utility operations should be attributed a utility capital structure (e.g., 30 to 40 percent common equity) and that the competitive enterprises should be financed in a manner comparable to other unregulated businesses (e.g., the average capital structure for the S&P 400 is about 75 percent common equity).

It is well known that competitive firms have far less ability to leverage their capital structures with debt than do regulated utility monopolies. This is due in part to the protected market that is the utility franchise, and in part to the stable cash flow characteristics of utility service; both of these features are absent in more cyclical competitive environments. The

AT&T system as it is now structured is a large and diverse organization comprised of enterprises with widely divergent operating and risk characteristics. As a result, AT&T's financial characteristics reflect a combination of influences and are not attributable to monopoly utility operations alone. Because AT&T is a combination of competitive and monopoly businesses, the total capital structure reflects the proportional risk contributions of the different parts. Since Bell's capital structure is a weighted average of the various enterprises, it is more equity rich than would be necessary for a pure utility monopoly rendering only local exchange service. This fact was recognized recently (1/25/82) by Standard & Poor's which concluded that, subsequent to the divestiture, Bell's local exchange utility enterprises will be able to sustain their credit ratings with a more highly leveraged conventional utility capital structure.

Thus, to avoid serious capital cost cross subsidies, the consolidated capital structure of AT&T must be subdivided into those portions attributable to low risk, highly leverageable utility operations on one hand, and those portions attributable to competitive, less leverageable market enterprises on the other hand. This is important for two reasons. First, the debt component of the capital structure is costed for ratemaking purposes on an embedded basis, which is generally less than the currently allowed rate for common equity capital. Second, and even more importantly, the return on the debt portion of the capital structure does not require the corresponding income tax allowance that is associated with an equity return.

There is no question that the extent to which competition can effectively replace regulation as a sufficient economic discipline varies between locations. Although toll service between densely populated urban centers is likely to enjoy the benefits of vigorous private carrier rivalry, small towns and rural areas in less populated states are not likely to be afforded those same benefits for at least a considerable period of time. This observation underscores the fact that the proper market definition is not nationwide in this instance.

Not surprisingly, state regulators have focused considerable attention on the prospective redistribution of regulatory control between federal and state jurisdictions. Control over local access charges and intrastate toll rates have been the foremost concern in this regard, and the arguments for state control have focused on the obvious fact that circumstances, and therefore proper solutions, differ between states.

What is somewhat surprising, however, is the fact that state regulators, perhaps reflecting their own inherently humble nature, have failed to articulate the other obvious reason why regulatory controls should, to the maximum extent possible, be lodged at the state level. That is, state regulatory Commissions and their staffs are far more experienced and knowledgable about the primary regulatory issue -- joint and common cost allocation.

All state regulatory commissions have increasingly grappled and dealt with common and joint cost allocation issues in recent years. Electric generation, transmission and distribution costs are all dominated by common and joint cost characteristics. Similarly, gas and water utility capacity costs are common to all customers on a system. Particularly in recent years, state regulatory awareness of cost-based rate design methods reflecting multifaceted (e.g., demand, energy and customer) cost responsibilities has grown substantially. The FCC does not have comparable background or experience in this area. Allocating non-traffic sensitive telephone utility costs, as has been suggested, on the singular criterion of subscriber line usage would be comparable to allocating all fixed electric generating costs purely on the basis of kilowatt hours consumed, without reference to demand responsibilities or delivery voltages. Both the necessity for interstate diversity in proper regulatory determinations and the state commissions' clear advantages in being able to deal with the central and fundamental problem of joint cost allocations, counsel in favor of retaining maximum regulatory authority at the state level.

In summary, it appears that the proposed settlement of the AT&T antitrust case offers a good framework within which to craft a more effectively competitive communications sector of our economy. However, careful scrutiny of the actual details of the divestiture plan and an implementation strategy that recognizes important jurisdictional differences (especially with respect to cost allocations and effective competition) will be essential if the potential benefits are to be realized.

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DISTRICT OF COLUMBIA
THE CHESAPEAKE AND POTOMAC TELEPHONE COMPANY
CLASS COST OF SERVICE STUDY
TWELVE MONTHS ENDED DECEMBER 31, 1980

RATE OF RETURN SUMMARY

ITEM NO.	DESCRIPTION	TOTAL COMPANY	LOCAL EXCHANGE	D.C. P.L.	CUST PREM EQUIPMENT	CENTREX	OTHER SERVICES	INTERSTATE TOLL	INTERSTATE P.L.
7200	RETURN	59,411,992	24,892,540	-1,332,547	-42,035,256	12,478,747	3,120,203	64,722,504	-2,434,132
7205	NET INVESTMENT BASE	550,941,760	95,400,104	17,557,594	136,806,736	97,853,464	20,168,892	139,097,568	44,057,384
7210	RATE OF RETURN	10.7837%	26.0928%	-7.5896%	-30.7260%	12.7525%	15.4704%	46.5303%	-5.5249%

DISTRICT OF COLUMBIA
THE CHESAPEAKE AND POTOMAC TELEPHONE COMPANY
CLASS COST OF SERVICE STUDY
TWELVE MONTHS ENDED DECEMBER 31, 1980

REVENUE AND EXPENSE SUMMARY

ITEM NO. DESCRIPTION	TOTAL COMPANY	LOCAL EXCHANGE	D.C. P.L.	CUST PREM EQUIPMENT	CENTREX	OTHER SERVICES	INTERSTATE TOLL	INTERSTATE P.L.
7000 TOTAL OPERATING REVENUES	375,720,000	82,154,872	7,039,765	45,597,200	66,169,000	19,120,316	139,396,672	16,240,101
OPERATING EXPENSES								
7005 TRAFFIC	20,110,104	6,280,523	140,233	1,165,157	5,269,956	420,995	6,290,142	551,078
7010 ACCOUNTING	10,309,200	2,271,729	235,909	2,010,773	2,074,276	251,249	2,886,036	579,313
7015 COMMERCIAL & MARKETING	43,124,216	12,637,970	700,753	9,002,596	7,740,691	766,384	10,422,676	1,903,139
7020 DEPRECIATION	50,831,652	6,044,201	1,540,077	20,923,440	8,032,213	904,770	9,223,796	3,275,147
7025 MAINTENANCE	77,494,952	11,947,958	2,431,805	27,300,376	11,142,224	2,406,223	16,195,767	6,070,605
7030 GENERAL OFFICE	10,203,882	1,817,916	301,190	2,611,046	1,045,813	326,455	2,522,992	770,470
7035 GENERAL SERVICES & LICENSES	8,026,492	737,447	476,702	2,525,309	600,277	104,090	3,137,868	424,753
7040 OPERATING RENTS	3,405,241	769,850	83,190	711,706	609,701	97,666	917,120	216,009
7045 RELIEFS & PENSIONS	27,952,112	5,109,111	731,759	7,564,054	5,301,161	701,692	6,509,625	1,872,710
7050 EXPENSE CHARGED CONSTRUCTION	-2,020,727	-455,592	-21,095	-27,309	-437,670	-212,461	-759,[illegible]	-104,790
7055 OTHER OPERATING EXP & RENT CREDIT	5,641,799	-282,433	-16,502	102,067	-44,832	8,269,340	-1,206,756	-1,179,092
7060 OPERATING EXPENSES	255,087,024	47,758,684	6,640,023	73,889,136	42,133,808	14,058,421	56,219,700	14,387,193
7065 COMPANY USE OPERATING EXPENSES	4,071,143	755,779	106,579	1,101,974	772,099	102,199	959,760	272,755
7070 TOTAL OPERATING EXPENSES	259,158,160	48,514,464	6,746,602	74,991,112	42,905,908	14,160,620	57,179,460	14,659,948
OPERATING TAXES								
7075 FEDERAL INCOME TAX CURRENT	3,319,216	321,047	118,172	920,784	658,607	67,874	936,202	296,530
7080 FEDERAL INCOME TAX DEFERRED	11,881,952	1,149,268	423,026	3,296,172	2,357,646	242,971	3,351,366	1,061,503
7085 INVESTMENT TAX CREDITS-NET	6,743,795	652,286	240,095	1,870,796	1,338,120	137,902	1,902,127	602,473
7090 FEDERAL INCOME TAX	21,944,962	2,122,601	781,294	6,087,752	4,354,373	448,747	6,189,691	1,960,506
7095 COMPANY USE FEDERAL INCOME TAX	30,128	5,593	789	8,155	5,714	756	7,103	2,018
7100 TOTAL FEDERAL INCOME TAXES	21,975,090	2,128,194	782,083	6,095,907	4,360,087	449,503	6,196,793	1,962,524
7103 STATE & LOCAL INCOME TAXES	6,040,979	584,307	215,074	1,675,820	1,198,646	123,530	1,703,890	539,685
7105 PROPERTY TAXES	1,864,959	322,145	59,547	462,812	325,965	68,077	473,027	153,386
7110 GROSS RECEIPTS TAX	19,619,446	4,289,998	367,596	2,380,956	3,455,157	998,408	7,278,898	848,434
7115 SOCIAL SECURITY TAX	7,460,756	1,310,779	184,844	1,911,199	1,339,083	177,249	1,664,552	473,050
7120 OTHER TAXES	5,180	998	133	1,107	939	193	1,486	329
7125 OTHER OPERATING TAXES	34,991,332	6,508,228	827,194	6,431,902	6,319,811	1,367,460	11,121,853	2,014,884
7130 COMPANY USE OTHER OPERATING TAXES	110,778	20,565	2,900	29,983	21,009	2,761	26,116	7,422
7135 TOTAL OTHER OPERATING TAXES	35,102,110	6,528,793	830,094	6,461,885	6,340,820	1,370,240	11,147,969	2,022,306
7140 TOTAL OPERATING EXPENSES & TAXES	315,835,360	57,171,450	8,358,779	87,548,904	53,606,816	15,980,363	74,524,220	18,645,778
7145 NET OPERATING INCOME	59,884,640	24,983,414	-1,319,014	-41,951,704	12,562,184	3,139,953	64,872,452	-2,405,677

DISTRICT OF COLUMBIA
THE CHESAPEAKE AND POTOMAC TELEPHONE COMPANY
CLASS COST OF SERVICE STUDY
TWELVE MONTHS ENDED DECEMBER 31, 1980

REVENUE AND EXPENSE SUMMARY

ITEM NO.	DESCRIPTION	TOTAL COMPANY	LOCAL EXCHANGE	D.C. P.L.	CUST PREM EQUIPMENT	CENTREX	OTHER SERVICES	INTERSTATE TOLL	INTERSTATE P.L.
7150	OTHER INCOME	214,655	37,169	6,841	53,302	38,125	7,858	54.194	17.165
7155	INTEREST CHARGED CONSTRUCTION	-45,385	-7,293	-2,613	-3,993	-6,475	-609	-13,427	-10,976
7160	MISCELLANEOUS DEDUCTIONS	-425,295	-73,643	-13,553	-105,607	-75,537	-15,569	-107,375	-34,010
7165	INTEREST UNRELATED TO CAPITAL	-225,100	-49,222	-4,210	-27,310	-39,644	-11,455	-83,516	-9,735
7170	MISCELLANEOUS CHARGES & CREDITS	483	106	9	59	85	25	179	21
7175	RETURN	59,411,992	24,892,540	-1,332,547	-42,035,256	12,478,747	3,120,203	64,722,504	-2,434.132

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DISTRICT OF COLUMBIA
THE CHESAPEAKE AND POTOMAC TELEPHONE COMPANY
CLASS COST OF SERVICE STUDY
TWELVE MONTHS ENDED DECEMBER 31, 1980

NET INVESTMENT BASE SUMMARY

ITEM NO. DESCRIPTION	TOTAL COMPANY	LOCAL EXCHANGE	D.C. P.L.	CUST PREM EQUIPMENT	CENTREX	OTHER SERVICES	INTERSTATE TOLL	INTERSTATE P.L.
PLANT IN SERVICE								
6000 LAND(211)	8,299,398	1,635,012	179,557	513,281	1,531,920	431,367	3,068,640	939,619
6005 BUILDINGS(212)	87,903,720	17,317,350	1,901,787	5,434,454	16,225,455	4,568,861	32,501,742	9,952,053
6010 CENTRAL OFFICE EQUIPMENT(221)	272,513,856	60,862,936	4,479,035	0	56,135,928	21,018,056	105,391,408	24,426,486
6015 STATION APPARATUS(231)	135,709,008	2,317,858	2,205,551	119,410,128	0	2,997,944	2,952,767	5,824,761
6020 STATION CONNECTIONS(232)	111,968,984	16,268,022	3,722,726	42,430,040	24,246,972	135,041	19,389,998	5,776,184
6025 LARGE PBX(234)	29,795,954	0	804,832	27,940,586	0	14	0	1,050,522
6030 OUTSIDE PLANT(241-244)	148,457,792	39,119,716	11,983,732	0	40,904,804	61,971	38,895,044	17,492,544
6035 FURNITURE & OFFICE EQUIPMENT(261)	40,488,416	6,968,087	1,306,874	10,274,739	7,054,342	1,461,025	10,128,111	3,295,244
6040 MOTOR VEHICLES & OTHER WORK EQUIP(264)	6,540,510	898,934	290,266	2,867,211	1,012,215	49,494	954,900	467,490
6045 TOTAL PLANT IN SERVICE(100.1)	841,677,696	145,307,936	26,874,360	208,872,448	147,111,648	30,723,774	213,402,600	69,224,912
PLANT UNDER CONSTRUCTION								
6050 SHORT TERM(100.2-01)	9,994,159	2,434,492	-27,525	-60,116	2,371,429	1,307,435	3,980,727	-12,283
6055 LONG TERM(100.2-02)	2,797,736	449,564	161,062	246,159	399,170	37,513	827,675	676,592
6060 PLANT UNDER CONSTRUCTION(100.2)	12,791,895	2,884,056	133,536	186,043	2,770,599	1,344,948	4,808,403	664,309
6061 PLANT HELD FOR FUTURE USE(100.3)	169,000	25,929	12,366	0	20,995	2,266	52,994	54,449
6065 MATERIALS & SUPPLIES(122)	2,326,992	416,972	67,609	603,670	424,019	71,679	569,399	173,644
6070 GROSS INVESTMENT	856,965,568	148,714,912	27,087,872	209,662,160	150,327,248	32,142,666	218,913,392	70,117,320
6075 ACCUMULATED PROVISION FOR DEPREC(171)	-218,735,808	-38,338,600	-6,685,471	-51,428,528	-37,103,944	-8,650,767	-57,592,568	-18,935,924
6080 ACCUMULATED DEFERRED INCOME TAXES(176)	-96,696,200	-16,722,772	-3,091,104	-23,973,484	-17,154,110	-3,559,185	-24,441,216	-7,754,334
6085 NET INVESTMENT BASE	541,533,568	93,653,544	17,311,298	134,260,144	96,069,192	19,932,716	136,879,616	43,427,064
6090 COMPANY USE NET INVESTMENT BASE	9,408,171	1,746,560	246,297	2,546,596	1,784,274	236,177	2,217,947	630,320
6095 TOTAL NET INVESTMENT BASE	550,941,760	95,400,104	17,557,594	136,806,736	97,853,464	20,168,892	139,097,568	44,057,384

THE CHESAPEAKE AND POTOMAC TELEPHONE COMPANY OF WEST VIRGINIA
FULLY DISTRIBUTED T STUDY
TWELVE MONTHS ENDED DECEMBER 31, 1980

RATE OF RETURN SUMMARY

ITEM NO.	DESCRIPTION	TOTAL COMPANY	EXCHANGE USE	STATE TOLL	STATE P.L.	CUST PREM EQUIPMENT	VERTICAL SERVICES	INTERSTATE TOLL	INTERSTATE P.L.
7200	RETURN	60,626,480	32,219,536	6,098,184	2,711,203	-911,740	792,970	16,666,168	3,050,075
7205	NET INVESTMENT BASE	673,636,736	227,712,144	145,063,168	31,559,236	92,771,912	6,470,496	151,997,120	18,062,614
7210	RATE OF RETURN	8.9999%	14.1493%	4.2038%	8.5908%	-0.9828%	12.2552%	10.9648%	16.8861%

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THE CHESAPEAKE AND POTOMAC TELEPHONE COMPANY OF WEST VIRGINIA

FULLY DISTRIBUTED STUDY

TWELVE MONTHS ENDED DECEMBER 31, 1980

REVENUE AND EXPENSE SUMMARY

ITEM NO.	DESCRIPTION	TOTAL COMPANY	EXCHANGE USE	STATE TOLL	STATE P.L.	CUST PREM EQUIPMENT	VERTICAL SERVICES	INTERSTATE TOLL	INTERSTATE P.L.
7000	TOTAL OPERATING REVENUES	346,837,632	113,342,144	63,538,232	13,063,342	61,148,424	3,363,219	82,662,840	9,719,426
	OPERATING EXPENSES								
7005	TRAFFIC	23,712,800	6,393,233	7,328,603	356,658	766,573	116,271	8,513,214	238,245
7010	ACCOUNTING	11,519,956	3,187,521	2,648,907	397,985	1,934,729	85,343	3,011,051	254,419
7015	COMMERCIAL & MARKETING	27,064,588	6,145,529	4,347,564	599,729	10,586,929	92,952	4,790,852	501,037
7020	DEPRECIATION	45,044,516	14,186,677	9,157,[illegible]9	2,041,691	8,434,969	436,813	9,591,595	1,194,804
7025	MAINTENANCE	79,081,248	23,793,836	14,709,540	3,201,502	19,489,264	688,625	15,374,205	1,824,276
7030	GENERAL OFFICE	9,439,883	2,970,450	2,037,111	408,818	1,533,330	78,761	2,173,996	237,417
7035	GENERAL SERVICES & LICENSES	7,548,422	1,106,754	1,170,131	441,182	2,707,777	39,226	1,792,095	291,260
7040	OPERATING RENTS	4,833,917	1,547,560	1,054,301	228,730	698,719	37,422	1,130,745	136,441
7045	RELIEFS & PENSIONS	25,783,688	7,047,754	5,437,999	817,964	5,813,802	154,609	6,012,655	498,905
7050	EXPENSE CHARGED CONSTRUCTION	-2,272,881	-863,542	-516,109	-105,355	-126,532	-59,200	-541,865	-60,279
7055	OTHER OPERATING EXP & RENT CREDIT	2,379,442	633,718	337,766	37,436	469,072	532,424	348,895	20,131
7060	OPERATING EXPENSES	234,135,600	66,149,496	47,713,788	8,426,340	52,308,632	2,203,247	52,197,440	5,136,655
7065	COMPANY USE OPERATING EXPENSES	3,582,962	979,372	755,677	113,666	807,900	21,485	835,533	69,329
7070	TOTAL OPERATING EXPENSES	237,718,560	67,128,872	48,469,464	8,540,006	53,116,532	2,224,731	53,032,972	5,205,984

THE CHESAPEAKE AND POTOMAC TELEPHONE COMPANY OF WEST VIRGINIA
FULLY DISTRIBUTED (STUDY
TWELVE MONTHS ENDED DECEMBER 31, 1980

REVENUE AND EXPENSE SUMMARY

ITEM NO.	DESCRIPTION	TOTAL COMPANY	EXCHANGE USE	STATE TOLL	STATE P.L.	CUST PREM EQUIPMENT	VERTICAL SERVICES	INTERSTATE TOLL	INTERSTATE P.L.
	OPERATING TAXES								
7075	FEDERAL INCOME TAX CURRENT	-699,018	-183,550	-116,279	-25,297	-130,142	-5,187	-213,225	-25,339
7080	FEDERAL INCOME TAX DEFERRED	14,815,978	3,890,417	2,464,573	536,181	2,758,423	109,931	4,519,389	537,063
7085	INVESTMENT TAX CREDITS-NET	8,711,805	2,297,568	1,449,171	315,275	1,621,954	64,640	2,657,403	315,793
7090	FEDERAL INCOME TAX	22,828,764	5,994,435	3,797,466	826,158	4,250,235	169,385	6,963,567	827,517
7095	COMPANY USE FEDERAL INCOME TAX	214,888	58,738	45,322	6,817	48,454	1,289	50,111	4,158
7100	TOTAL FEDERAL INCOME TAXES	23,043,652	6,053,173	3,842,787	832,975	4,298,688	170,673	7,013,678	831,675
7105	PROPERTY TAXES	8,019,776	2,688,548	1,750,172	393,551	1,050,986	76,281	1,835,383	224,854
7110	GROSS RECEIPTS TAX	8,945,741	2,923,355	1,638,797	336,934	1,577,158	86,745	2,132,065	250,686
7115	SOCIAL SECURITY TAX	7,158,675	1,956,763	1,509,825	227,102	1,614,165	42,926	1,669,375	138,518
7120	OTHER TAXES	1,049,195	328,562	213,173	40,759	188,063	8,873	243,768	25,998
7125	OTHER OPERATING TAXES	25,173,388	7,897,227	5,111,968	998,346	4,430,372	214,826	5,880,591	640,056
7130	COMPANY USE OTHER OPERATING TAXES	198,498	54,258	41,865	6,297	44,758	1,190	46,289	3,841
7135	TOTAL OTHER OPERATING TAXES	25,371,886	7,951,485	5,153,833	1,004,643	4,475,130	216,016	5,926,880	643,897
7140	TOTAL OPERATING EXPENSES & TAXES	286,134,080	81,133,536	57,466,084	10,377,624	61,890,352	2,611,421	65,973,532	6,681,556
7145	NET OPERATING INCOME	60,703,552	32,208,608	6,072,148	2,685,718	-741,928	751,799	16,689,309	3,037,870

THE CHESAPEAKE AND POTOMAC TELEPHONE COMPANY OF WEST VIRGINIA
FULLY DISTRIBUTED C STUDY
TWELVE MONTHS ENDED DECEMBER 31, 1980

REVENUE AND EXPENSE SUMMARY

ITEM NO.	DESCRIPTION	TOTAL COMPANY	EXCHANGE USE	STATE TOLL	STATE P.L.	CUST PREM EQUIPMENT	VERTICAL SERVICES	INTERSTATE TOLL	INTERSTATE P.L.
7150	OTHER INCOME	145,533	49,197	31,341	6,818	20,043	1,398	32,839	3,902
7155	INTEREST CHARGED CONSTRUCTION	1,144,104	411,016	252,524	72,273	42,154	53,005	266,810	46,322
7160	MISCELLANEOUS DEDUCTIONS	-231,874	-78,381	-49,933	-10,863	-31,933	-2,227	-52,319	-6,217
7165	INTEREST UNRELATED TO CAPITAL	-759,929	-248,335	-139,214	-28,622	-133,978	-7,369	-181,116	-21,295
7170	MISCELLANEOUS CHARGES & CREDITS	-374,916	-122,518	-68,682	-14,121	-66,099	-3,635	-89,355	-10,506
7175	RETURN	60,626,480	32,219,586	6,098,184	2,711,203	-911,740	792,970	16,666,168	3,050,075

THE CHESAPEAKE AND POTOMAC TELEPHONE PANY OF WEST VIRGINIA
FULLY DISTRIBUTED CO., STUDY
TWELVE MONTHS ENDED DECEMBER 31, 1980

NET INVESTMENT BASE SUMMARY

ITEM NO. DESCRIPTION	TOTAL COMPANY	EXCHANGE USE	STATE TOLL	STATE P.L.	CUST PREM EQUIPMENT	VERTICAL SERVICES	INTERSTATE TOLL	INTERSTATE P.L.
PLANT IN SERVICE								
6000 LAND(211)	5,064,484	1,609,513	1,234,872	288,247	239,760	100,233	1,373,925	197,933
6005 BUILDINGS(212(	63,928,524	20,316,742	15,840,131	3,638,513	3,026,475	1,265,238	17,342,932	2,498,494
6010 CENTRAL OFFICE EQUIPMENT(221)	284,245,280	93,915,536	70,865,696	18,413,654	5,347,723	6,646,365	76,618,120	12,418,186
6015 STATION APPARATUS(231)	58,694,200	2,242,153	1,265,335	672,783	52,508,200	150,013	1,271,903	583,814
6020 STATION CONNECTIONS(232)	82,141,264	25,866,736	14,680,440	2,153,943	23,537,288	20,325	14,867,321	1,015,213
6025 LARGE PBX(234)	20,561,716	0	0	75,276	20,008,866	0	0	477,575
6030 OUTSIDE PLANT(241-244)	338,573,856	141,984,640	82,602,824	16,780,494	6,002,642	77,843	84,233,152	6,892,239
6035 FURNITURE & OFFICE EQUIPMENT(261)	8,034,514	2,698,770	1,753,114	394,236	1,050,979	75,741	1,837,145	224,530
6040 MOTOR VEHICLES & OTHER WORK EQUIP(264)	16,070,134	5,476,421	3,175,612	634,945	3,249,461	8,916	3,235,116	289,663
6045 TOTAL PLANT IN SERVICE(100.1)	877,314,048	294,110,528	191,458,032	43,052,092	114,971,392	8,344,675	200,779,632	24,597,646
PLANT UNDER CONSTRUCTION								
6050 SHORT TERM(100.2-01)	14,252,089	5,665,290	3,313,205	457,011	1,021,359	125,624	3,460,722	208,877
6055 LONG TERM(100.2-02)	12,107,912	4,349,736	2,672,429	764,852	446,110	560,950	2,823,616	490,219
6060 PLANT UNDER CONSTRUCTION(100.2)	26,360,000	10,015,026	5,985,634	1,221,863	1,467,469	686,575	6,284,339	699,097
6065 MATERIALS & SUPPLIES(122)	9,535,219	2,901,478	2,045,974	385,207	1,699,810	73,936	2,202,889	225,923
6070 GROSS INVESTMENT	913,209,280	307,027,040	199,489,632	44,659,164	118,138,672	9,105,186	209,266,864	25,522,666
6075 ACCUMULATED PROVISION FOR DEPREC(171)	-176,096,720	-56,896,352	-40,691,452	-9,901,339	-17,929,500	-1,971,343	-43,059,628	-5,647,098
6080 ACCUMULATED DEFERRED INCOME TAXES(176)	-76,790,840	-26,058,090	-16,543,262	-3,620,998	-10,439,583	-743,189	-17,315,120	-2,070,595
6085 NET INVESTMENT BASE	660,321,728	224,072,592	142,254,912	31,136,830	89,769,592	6,390,654	148,892,112	17,804,974
6090 COMPANY USE NET INVESTMENT BASE	13,315,013	3,639,546	2,808,249	422,406	3,002,319	79,842	3,105,009	257,641
6095 TOTAL NET INVESTMENT BASE	673,636,736	227,712,144	145,063,168	31,559,236	92,771,912	6,470,496	151,997,120	18,062,614

THE C&P TELEPHONE COMPANY OF MARYLAND
FULLY DISTRIBUTED COST STUDY
TWELVE MONTHS ENDED DECEMBER 31, 1980

RATE OF RETURN SUMMARY

ITEM NO.	DESCRIPTION	EXCHANGE SERVICE	STATE TOLL	STATE P. L.	CUST PREM EQUIPMENT
9953	NET OPERATING INCOME	98942576.	15646544.	354784.	-41945216.
9954	NET INVESTMENT BASE	647896512.	194947080.	107679720.	382444704.
9955	RATE OF RETURN	15.2714%	8.0260%	0.3295%	-10.9677%

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FULLY DISTRIBUTED COST STUDY
TWELVE MONTHS ENDED DECEMBER 31, 1980

RATE OF RETURN SUMMARY

ITEM NO.	DESCRIPTION	VERTICAL SERVICES	INTERST TOLL	INTERST P. L.	TOTAL COMPANY
9953	NET OPERATING INCOME	12055423.	79800128.	-1277126.	163582144.
9954	NET INVESTMENT BASE	17791458.	307286592.	61826716.	1719873280.
9955	RATE OF RETURN	67.7596%	25.9693%	-2.0657%	9.5113%

THE C&P TELEPHONE COMPANY OF MARYLAND
FULLY DISTRIBUTED COST STUDY
TWELVE MONTHS ENDED DECEMBER 31, 1980

REVENUE AND EXPENSE SUMMARY

ITEM NO.	DESCRIPTION	EXCHANGE SERVICE	STATE TOLL	STATE P. L.	CUST PREM EQUIPMENT
9900	TOTAL OPER REVENUES(300)	352866912.	94140832.	35266720.	223505408.
	OPERATING EXPENSES				
9902	MAINTENANCE	57065652.	16209536.	8562180.	84723369.
9904	DEPRECIATION	41824380.	12747152.	6347755.	37708783.
9906	TRAFFIC	16835950.	7704575.	899775.	3212259.
9908	COMM & MKTG	40331624.	8262810.	3014033.	41616596.
9910	ACCOUNTING	8372871.	2421037.	981430.	6075997.
9912	GENERAL OFFICE	8739627.	2687855.	1302338.	6596560.
9914	OPERATING RENTS	4963067.	1599026.	749418.	4540111.
9916	RELIEF & PENS IS	20733230.	6024334.	2762524.	26236972.
9918	GEN SVCS & LICENSES	3329837.	2585378.	1415491.	7674180.
9920	EXP CHGD CONSTR	-2462032.	-691319.	-323637.	-367666.
9923	OTHER OPERATING EXPENSES	2151541.	645950.	359254.	2498110.
9924	TOTAL OPERATING EXPENSES	201890800.	60998204.	26150616.	222515984.
9925	COMPANY USE OPER. EXPENSES	4713681.	1551502.	628056.	5964937.
	OPERATING TAXES				
9926	FIT CURRENT	450943.	183175.	101177.	399278.
9928	FIT DEFERRED	10688536.	4341734.	2378172.	9463952.
9930	ITC NET	5829406.	2367964.	1307954.	5161602.
9932	TOTAL FED INC TAX	16968764.	6892873.	3807303.	15024832.
9933	COMPANY USE F.I.T.	559847.	184273.	74595.	708459.
9934	STATE & LOC INC TAX	127185.	51663.	28536.	112614.
9936	CAPITAL STOCK TAX	4023541.	1207975.	671831.	2311070.
9938	PROPERTY TAX	12081208.	3611950.	1979355.	6505569.
9940	GROSS REC TAX	7070355.	1886289.	706635.	4478353.
9941	SOC SEC TAX	5276758.	1736838.	703081.	6677485.
9943	OTHER TAXES	802482.	237930.	107364.	633101.
9946	TOTAL OTHER TAXES	29254344.	8680983.	4168266.	20605578.
9947	COMPANY USE OTHER TAXES	409509.	134787.	54563.	518214.
9948	TOTAL OPER TAXES	47319852.	15944582.	8133264.	36969696.
9950	TOT OPER EXP AND TAXES	253924336.	78494289.	34911936.	265450624.
9952	NET OPERATING INCOME	98942576.	15646544.	354784.	-41945216.

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THE C&P TELEPHONE COMPANY OF MARYLAND
FULLY DISTRIBUTED COST STUDY
TWELVE MONTHS ENDED DECEMBER 31, 1980

NET INVESTMENT BASE SUMMARY

ITEM NO.	DESCRIPTION	EXCHANGE SERVICE	STATE TOLL	STATE P. L.	CUST PREM EQUIPMENT
	PLANT IN SERVICE				
8000	LAND(211)	5044635.	2212225.	719622.	871105.
8002	BUILDINGS(212)	61918780.	27153260.	8332768.	10692104.
8004	CENTRAL OFFICE EQUIPMENT(221)	377370144.	102430064.	47353392.	44464356.
8006	STATION APPARATUS(231)	13135733.	4294503.	6581327.	204817360.
8008	STATION CONNECTIONS(232)	82983456.	27129604.	8332744.	110682544.
8010	LARGE PBX (234)	0.	0.	1069143.	66752716.
8012	OUTSIDE PLANT(241-244)	349441388.	102808888.	72453576.	36202888.
8014	FURNITURE & OFFICE EQUIPMENT(261)	14420781.	4311423.	2362667.	7765410.
8016	MOTOR VEHICLES AND OTHER EQUIPMENT(264)	13202872.	3972876.	2618205.	11813132.
8018	TOTAL PLANT IN SERVICE(100.1)	917518528.	274312364.	150323952.	494071520.
	PLANT UNDER CONSTRUCTION				
8020	SHORT TERM(100.2-01)	15256359.	4066537.	1962775.	2303390.
8022	LONG TERM(100.2-02)	10824396.	3256726.	1465576.	1591366.
8024	TOTAL PLT UNDER CONST(100.2)	26080754.	7323263.	3428351.	3894756.
8026	PLANT HELD FOR FUTURE(100.3)	4196.	1654.	742.	636.
8027	MATERIALS & SUPPLIES(122)	3417546.	1021753.	559922.	1840303.
8028	MATERIALS & SUPPLIES(122)	2569956.	845898.	342424.	3252156.
8029	MATERIALS & SUPPLIES(122)	5987503.	1867650.	902346.	5092460.
8030	INV IN AFFILIATES(101.1)	5825.	1741.	954.	3137.
8032	GROSS INVESTMENT	949596864.	283507168.	154656352.	503062496.
8040	DEPRECIATION RESERVE(171)	-226885280.	-66529712.	-33981520.	-87946360.
8041	NET INVESTMENT SUBTOTAL	722711616.	216977456.	120674832.	415116128.
8042	ACCUM DEF INC TAXES(176)	-89721504.	-26936832.	-14981269.	-51534908.
8044	NET INVESTMENT BASE	632990016.	190040624.	105693560.	363581216.
8046	COMPANY USE N.I.B.	14906525.	4906465.	1986161.	18863494.
8048	TOTAL NET INVESTMENT BASE	647896512.	194947088.	107679720.	382444704.

FULLY DISTRIBUTED COST STUDY
TWELVE MONTHS ENDED DECEMBER 31, 1980

REVENUE AND EXPENSE SUMMARY

ITEM NO.	DESCRIPTION	VERTICAL SERVICES	INTERST TOLL	INTERST P. L.	TOTAL COMPANY
9900	TOTAL OPER REVENUES(300)	17957574.	212552416.	24587110.	960877184.
	OPERATING EXPENSES				
9902	MAINTENANCE	1676018.	24911490.	7541718.	200689392.
9904	DEPRECIATION	653298.	19415306.	3826750.	124723520.
9906	TRAFFIC	313991.	14250499.	719034.	43936172.
9908	COMM & MKTG	270365.	15107360.	2453775.	111053608.
9910	ACCOUNTING	273145.	4537251.	676547.	23338309.
9912	GENERAL OFFICE	227297.	4349761.	887963.	24073364.
9914	OPERATING RENTS	98200.	2746793.	513095.	15214472.
9916	RELIEF & PENSIONS	445727.	11826586.	2503989.	71333024.
9918	GEN SVCS & LICENSES	140773.	5026936.	892604.	21065192.
9920	EXP CHGD CONSTR	-118865.	-1106973.	-197141.	-5267634.
9923	OTHER OPERATING EXPENSES	59384.	1015569.	204031.	6933842.
9924	TOTAL OPERATING EXPENSES	4239334.	102080568.	20022366.	637893248.
9925	COMPANY USE OPER. EXPENSES	101335.	2688757.	569278.	16217456.
	OPERATING TAXES				
9926	FIT CURRENT	16717.	320812.	64548.	1536651.
9928	FIT DEFERRED	396240.	7604094.	1529960.	36422700.
9930	ITC NET	216108.	4147243.	834434.	19864796.
9932	TOTAL FED INC TAX	629064.	12072149.	2428942.	57824149.
9933	COMPANY USE F.I.T.	12036.	319345.	67614.	1926157.
9934	STATE & LOC INC TAX	4715.	90483.	18205.	433402.
9936	CAPITAL STOCK TAX	111053.	1877190.	381552.	10606217.
9938	PROPERTY TAX	295163.	5661425.	1122103.	31256780.
9940	GROSS REC TAX	359814.	4258869.	492649.	19252988.
9941	SOC SEC TAX	113441.	3009945.	637282.	18154730.
9945	OTHER TAXES	27394.	437945.	74787.	2320999.
9946	TOTAL OTHER TAXES	906864.	15267394.	2708373.	81591712.
9947	COMPANY USE OTHER TAXES	8804.	233590.	49457.	1408918.
9948	TOTAL OPER TAXES	1561482.	27982962.	5272591.	143104336.
9950	TOT OPER EXP AND TAXES	5902152.	132752288.	25864236.	797295040.
9952	NET OPERATING INCOME	12055423.	79800128.	-1277126.	163582144.

THE C&P TELEPHONE COMPANY OF MARYLAND
FULLY DISTRIBUTED COST STUDY
TWELVE MONTHS ENDED DECEMBER 31, 1980

NET INVESTMENT BASE SUMMARY

ITEM NO.	DESCRIPTION	VERTICAL SERVICES	INTERST TOLL	INTERST P. L.	TOTAL COMPANY
	PLANT IN SERVICE				
8000	LAND(211)	58344.	4394582.	634866.	13935372.
8002	BUILDINGS(212)	716122.	53939908.	7792465.	171045344.
8004	CENTRAL OFFICE EQUIPMENT(221)	18239216.	162525328.	36806372.	789189440.
8006	STATION APPARATUS(231)	2320158.	6014283.	2984644.	240148192.
8008	STATION CONNECTIONS(232)	135408.	38384396.	4470173.	272128928.
8010	LARGE PBX (234)	0.	0.	1955376.	69777232.
8012	OUTSIDE PLANT(241-244)	506258.	152119268.	28123954.	741657408.
8014	FURNITURE & OFFICE EQUIPMENT(261)	352316.	6757783.	1339401.	37309780.
8016	MOTOR VEHICLES AND OTHER EQUIPMENT(264)	88584.	5825895.	1111876.	38633460.
8018	TOTAL PLANT IN SERVICE(100.1)	22416406.	429962176.	85219128.	2373825280.
	PLANT UNDER CONSTRUCTION				
8020	SHORT TERM(100.2-01)	1048129.	6301266.	1147704.	32086160.
8022	LONG TERM(100.2-02)	211028.	5425105.	940650.	23714848.
8024	TOTAL PLT UNDER CONST(100.2)	1259158.	11726371.	2088354.	55801008.
8026	PLANT HELD FOR FUTURE(100.3)	39.	3193.	518.	10978.
8027	MATERIALS & SUPPLIES(122)	83496.	1601511.	317422.	8841955.
8028	MATERIALS & SUPPLIES(122)	55249.	1465943.	310377.	8841955.
8029	MATERIALS & SUPPLIES(122)	138745.	3067454.	627799.	17683910.
8030	INV IN AFFILIATES(101.1)	142.	2730.	541.	15070.
8032	GROSS INVESTMENT	23814492.	444761920.	87936344.	2447336448.
8040	DEPRECIATION RESERVE(171)	-3867114.	-103627904.	-19401616.	-542239552.
8041	NET INVESTMENT SUBTOTAL	19947378.	341134016.	68534728.	1905096960.
8042	ACCUM DEF INC TAXES(176)	-2476383.	-42350340.	-8508296.	-236509712.
8044	NET INVESTMENT BASE	17470996.	298783680.	60026432.	1668587264.
8046	COMPANY USE N.I.B.	320463.	8502914.	1800283.	51286024.
8048	TOTAL NET INVESTMENT BASE	17791458.	307286592.	61826716.	1719873280.

Senator SPECTER. Thank you very much.

With that, we will conclude our hearings. Thank you all for coming, ladies and gentlemen.

[Whereupon, at 11:40 a.m., the committee was adjourned.]

APPENDIX

RESPONSES TO COMMITTEE QUERIES FROM A.T. & T.

1. The Justice Department has now filed its competitive impact statement (CIS). That document explains the Government's understanding of the proposed settlement in greater detail than the modified decree itself does. Do you agree that the CIS accurately describes the effect of the decree? Please identify specifically any aspects of the CIS that do not accurately characterize AT&T's interpretation of the proposed settlement.

ANSWER The Justice Department's competitive impact statement does not contain any constructions of the modified decree with which we disagree. The accuracy of statements in the CIS as to the effect of the decree after divestiture will, as the CIS states, depend upon the application and enforcement of the Communications Act and State regulatory statutes to the divested entities.

2. What percentage of the nation's intercity transmission service revenues does AT&T receive? Please identify specifically AT&T's market share for the following services and facilities. Wherever possible, identify AT&T's market share for both interstate and intrastate interexchange offerings:

--private line services,
--message toll services,
--digital private line services,
--foreign exchange services.

ANSWER To quantify AT&T's or any other's share of the nation's intercity transmissions service revenues would require quantification of the total revenue in that market. This is not possible because (1) all suppliers of intercity transmission services are not required to report their revenues to the FCC, (2) those suppliers who do report their revenues do not all do so in a consistent manner and (3) a significant portion of intercity transmission services are supplied by organizations for their own use, in which instance a revenue is not meaningful.

However, explosive growth in telecommunications competition, especially within the last year or two, demonstrates that the market is rapidly becoming extremely competitive. For example, in the long distance calling market there are more than 200 other common carriers, domestic satellite carriers and resale carriers offering service in some 300 communities in 43 states. Their services are available to 65% of the total U.S. population and over 90% of the population in urban areas where the highest telecommunications traffic is concentrated. One of the major competitors - MCI - already has over 700,000 customers and in the last quarter of 1981 doubled its revenues compared to the year earlier quarter. MCI has stated that it sees "no reason this growth rate can't continue." Other competitors have experienced similar growth rates. If Bell competitors in the intercity long distance market continue to increase their revenues annually at a rate of 50%, which is a conservative projection of their recent performance, these companies will capture about 20% of the market in about 5 years. However, other competitors will also enter the market, further accelerating the growth rate of competition.

In any event, revenue share is misleading, not only because revenues are not measurable or reported in a consistent manner, but because such a number would mask the distribution of who actually receives the revenues. Today the Bell System acts as the collection and disbursal agency - via the separations and settlements and division of revenues processes - for the BOCs and the independent telephone companies. If the Modification of Final Judgment had been in effect in 1981, with access charge payments comparable to current separations levels, we estimate that less than 50% of today's interexchange service revenues would remain with the AT&T interexchange entity.

3. How many areas of the country are there where AT&T is the only provider of intercity service?

ANSWER Competitive long distance services are available to 65% of the total U.S. population in some 300 communities in 43 states. About 90% of the people living in urbanized Standard Metropolitan Statistical Areas have access to competitive long distance services. Moreover, competing carriers, through their own facilities augmented by resale of AT&T services, can and do serve all areas of the country.

Private line and Domsat services are more broadly available and readily extended by the construction of ground stations to every part of the U.S. Private microwave systems are larger in their geographic span than the Bell System's microwave network.

3. (continued) Even where companies other than AT&T provide intercity services, don't they sometimes rely heavily on interexchange facilities they have leased from AT&T"

ANSWER Because of FCC policy of open entry, competitors provide their own facilities whenever they desire, and interconnect with others' interexchange facilities where it is more economical for them to do so.

Competitors are growing rapidly, and sometimes choose to lease facilities initially on new routes or on routes for which there is not sufficient traffic to justify additional construction. Based on the most recent information submitted to the FCC by the three largest specialized common carriers, 47% of the intercity facilities which they lease are leased from someone other than AT&T.

4. With respect to the extent of market power possessed by AT&T Long Lines, I understand that the Telepak [sic] tariff, which provided multiple private lines as a single offering, was withdrawn in 1981, and users were then faced with a 16% private line rate increase and then a 16% general rate increase. Is there any evidence that a significant number of affected subscribers shifted their business away from AT&T? Please provide us with any studies in your possession that quantify the extent of any such shifts.

ANSWER Withdrawal of the Telpak tariff and subsequent private line and general rate increases took place in May and June of 1981. Telpak would have been withdrawn in 1977, but was delayed by a court order obtained by the United States. The private line rate increases were in response to an FCC order prescribing a cost manual. The general rate increase of 16% represented a rate increase of about 4% per year since the FCC's prior determination of AT&T's cost of capital in 1976.

With the complexities involved in the reconfiguration of private line networks customer reaction has been slow to develop. It will probably be two to three years before the full impact is known.

However, there are indications of decreased demand since the rate increases took effect. First, although the economic downturn may be a factor, private line revenue growth has significantly declined. Second, there are clear indications of customer reaction to the rate activity in competitive revenue losses experienced on several high volume business and government accounts. These types of accounts are generally the first to react to rate changes. For example, for a sample of six customers there has been a 17% decrease in revenues for series 2/3000 channels used for Common Control Switching Arrangements (CCSA) and enhanced private switched communications service (EPSCS) networks.

Moreover, with respect to the general concept of "market power", it is clear that AT&T Long Lines does not and cannot "control" entry into the markets it serves or determine unilaterally the prices it charges for services, the latter being a factor of both regulatory action and the prices of competitive offerings.

5. Is it the intent of AT&T to establish a separate subsidiary for its unregulated activities?

ANSWER Yes, in order to comply with the FCC's CI-II order. We have filed a capitalization plan for Advanced Communications Service and other enhanced services. Later this year, we plan to make further filings with the FCC looking to the January 1, 1983 effective date of CI-II as it pertains to other enhanced services and customer premises equipment.

5. (continued) Does AT&T believe, nevertheless, that the Computer Rules should be modified to eliminate the separate subsidiary requirement?

ANSWER We will comply with the requirements of CI-II. Nevertheless, we continue to believe that the stringency of the CI-II separate subsidiary requirements needs to be restudied, particularly in light of 3 factors: (1) the substantial divestiture called for in the Modified Final Judgment, (2) the growing competitive communications marketplace and (3) the public interest in having AT&T as a strong, innovative, productive, competitive force in all aspects of that marketplace.

Short of "eliminating" the subsidiary requirements, we believe the Commission should modify some of the more onerous conditions imposed by its Computer Inquiry decisions, such as the prohibition against providing transmission facilities within the Detariffed/Unregulated AT&T entity and the requirement to treat embedded and new customer premises equipment differently.

6. Would AT&T oppose the inclusion of structural safeguards between its regulated and unregulated activities in future telecommunications legislation?

ANSWER We cannot answer this question without knowing what "structural" provisions are referred to and whose interests are to be "safeguarded." In general terms, the notion of a structurally separated entity as such is not an insurmountable problem if the organizational requirements and any operational or transactional requirements which may apply to such an entity make good managerial, operational and financial sense, and if such requirements are uniformly applied to all participants in the competitive marketplace. The serious problems with structural separation come in: 1) the conditions and restrictions attached to the lines of business the subsidiary can engage in; 2) the kinds of transactions with other Bell entities and non-Bell organizations that are blocked or impeded; and 3) limitations on how the separate entity may be managed, financed, etc.

We understand the concern that the competitive and non-competitive activities not cross-subsidize one another. But, given the competitive nature of all of its activities after divestiture of the exchange operations of the BOCs, the prior concerns over cross-subsidy should no longer exist. Moreover, as we testified before the Committee in January, cost allocation and accounting mechanisms resolve all legitimate concerns of cross-subsidization. We are concerned when the cross-subsidy issue is used to rationalize discriminatory and penal restraints that would have anticompetitive effects on AT&T, Western Electric, Bell Laboratories and the Bell Operating companies.

7. The settlement requires the transfer of intrastate long distance facilities of [sic] AT&T. Presumably, AT&T will thus be designing, constructing, controlling, and administering the network, while the BOCs [will] still be limited to providing local access. Do you believe this could create any competitive problems for independent equipment manufacturers by making it more difficult for them to obtain access to network information than it will be for Western Electric to obtain such information?

ANSWER No. Depending on the size of exchange areas, we expect that approximately half of the intra-state long distance traffic will remain with the BOCs. In addition, today many non-Bell suppliers provide telecommunications products and services used in Bell System network operations (for quantification, see the answer to Question 8 below) and in independent telephone companies which serve some 20% of U.S. telephones. AT&T's carrier operations have every incentive to procure the best products at the best prices, as do the BOCs. Failure to do so would only impair their ability to compete.

We are obligated, under Computer Inquiry II, to make network information available to all suppliers at the same time and on the same terms and conditions.

It should be noted that it is not accurate to characterize the decree as requiring "the transfer of intrastate long distance facilities to AT&T." AT&T shareowners own stocks in companies that own these facilities today and would own stocks in companies that own them after divestiture.

8. With respect to the types of equipment used to provide long distance telephone service, how much competition currently exists, and are there a significant number of products needed by AT&T Long Lines for which Western Electric is the only current supplier?

ANSWER There is significant competition today from domestic and foreign manufacturers for virtually all of the equipment used to provide long distance telephone service. Moreover, there are many large and technologically advanced corporations which have the capability of offering such equipment.

It is true that Western Electric's No. 4 ESS is the only suitable product available at this time for certain large toll switching applications because it is innovative equipment where only Western Electric has taken the development and manufacturing risk. However, there are several other manufacturers which currently offer smaller size toll switches.

8. (continued) Besides equipment, what products and services do you expect that Western and Bell Labs will provide to AT&T's long distance operations?

ANSWER We expect that Western Electric and Bell Laboratories will continue to provide research and development and engineering and installation services as well as the maintenance, record keeping, operational support systems and services that are necessary efficiently to plan, operate and manage AT&T's long distance operations. Western Electric and Bell Laboratories' products and services will be used where it is judged that they will be the most effective in the competitive marketplace.

9. Is it expected that Western Electric and Bell Labs will remain intimately involved in the coordination and management of the intercity network?

ANSWER Western Electric is involved in intercity network operations as a supplier of technology and equipment. We believe that it is essential that the technological integration of R&D and the manufacturing operations continue for the AT&T portion of the intercity network. That organizational structure and close integration of functions is essential for AT&T to compete successfully. It is also essential in the public interest generally and to national security and emergency preparedness in particular to continue these relationships in the future.

9. (continued) If so, won't this provide funds and network information that give AT&T CPE operations an advantage over independent manufacturers?

ANSWER The important interface requirements for CPE are those related to the local distribution network to which CPE directly interconnects. Because this interface will be completely under the control of the divested BOCs and subject to FCC standards, the AT&T CPE operations will have no advantage over any other supplier of CPE.

10. Eric Nelson, Western Electric's Director or Purchasing, is quoted in the January 17 New York Times as saying that Western Electric hopes to sell its purchasing expertise to the Bell Operating Companies. In your view, would the recent settlement permit Western to become the prime purchasing agent for the BOCs?

ANSWER Under the terms of the proposed Modification of Final Judgment the Standard Supply Contract between Western Electric and the BOCs must be terminated. The services of Western Electric's

Purchasing Department would be one of the options for purchase of telecommunications equipment that the local exchange companies will have. Thus, the former relationship will be severed and any new relationship must be negotiated between the then independent BOCs and Western Electric completely at arm's length.

11. Roughly how many patents does AT&T have today? How many of them were obtained in the past decade?

ANSWER As of March 1, 1982 AT&T owned or controlled approximately 9,750 U.S. patents. Approximately 5,000 of these were developed during the past decade.

11. (continued) How many of them pertain to network transmission? To terminal equipment?

ANSWER Although patented inventions generally have applicability to various products, since January 1, 1971, we have classified the claims of our issuing U.S. patents as applicable to various categories of equipment. Such classification, however, does not represent a determination of actual use of those inventions in the identified categories. The number of patents classified as applicable to transmission facilities, including transmission media such as wire and cable, as of March 5, 1982 was approximately 875 and those classified as applicable to terminal equipment was approximately 575.

12. How many American companies hold licenses to AT&T patents?

ANSWER As of April 1, 1982, we had patent license agreements with 417 American licensees. While the great majority of these are companies, the number includes government agencies, individuals and others. Each license agreement with a corporate licensee includes the right of the licensee to extend sub-licenses to its subsidiaries for so long as they remain subsidiaries. Because the licensee is under no obligation to advise us when such sub-licenses are granted, the total number of American licensee companies is not known to us. It is undoubtedly many times greater than 417.

12. (continued) How many foreign companies?

ANSWER As of April 1, 1982, we had patent license agreements with 215 foreign licensees. As explained in the previous answer, because corporate licensees have the right to sub-license their subsidiaries, the actual number is undoubtedly much greater.

12. (continued) How many companies have applied for licenses but have not yet received them?

ANSWER Requests for licenses--new, supplementary and replacing--are received and acted upon continuously. The number of requests being processed at any particular time will vary. Also, often a company requesting licenses will change its mind before the license agreement is executed. As of March 5, 1982, our attorneys were preparing patent license agreements in response to 20 requests.

13. Is it the case that monopoly ratepayers have paid for work that will lead to AT&T patents that will not be issued until after the restructuring occurs?

ANSWER No. Bell System ratepayers have paid for telephone service received, under tariff, from the Bell Operating Companies. The Bell Operating Companies use the revenues received from the ratepayers to carry on their business of providing telephone service--they purchase, install and maintain the necessary facilities, acquire other necessary properties and make arrangements for ongoing research and development in order to incorporate the latest innovations in providing the most efficient service at the lowest cost to the ratepayer. The patents that ensue from this research are the property of the AT&T Company.

The courts have affirmed that the ratepayer pays for service and has no ownership interest in the property acquired by the Operating Company. In Board of Public Utilities Commissioners et al. v. New York Telephone Company, 271 U.S. 23 (1926), the U.S. Supreme Court considered the rights of monopoly ratepayers to have the telephone company's depreciation reserves used to reduce the rates charged for service. The Court stated:

> "The revenue paid by the customer for service belongs to the company. . . . Customers pay for service, not for property used to render it. . . . By paying bills for service they do not acquire any interest, legal or equitable, in the property used for their convenience or in the funds of the company. Property paid for out of monies received for service belongs to the company. . . ."

Philadelphia Suburban Water Company v. Pennsylvania Public Utilities Commission, 427 Atl. 2d 1244 (1981), quoted Board of Public Commissioners v. New York Telephone Company with approval.

13. (continued) How many patents can be expected to result from research work currently in progress?

There is no way to predict the number of patents that will issue from any research work.

14. After the proposed settlement is approved, will AT&T license its pre-settlement patents on a nondiscriminatory basis to any applicant willing to pay reasonable royalties?

ANSWER As of April 1, 1982, AT&T was party to approximately 700

Patent License Agreements with more than 600 companies throughout the world, including most of the major manufacturers of telecommunications equipment such as IT&T, GTE, Nippon Electric, Northern Electric and Stromberg Carlson. Under most of these agreements, the patents so licensed include patents issuing on inventions made during the period 5 years after the effective dates of the agreements. With respect to agreements that became effective January 1, 1982, all Bell patents issuing on inventions made through December 31, 1986 (i.e., patents issuing well into 1989) are licensed for the lives of those patents. We have no reason to believe that such patents will not continue to be broadly licensed, in the same way as other companies determine how their intellectual property can best be used.

14. (continued) Will AT&T license its post-settlement patents on a nondiscriminatory basis to any applicant willing to pay reasonable royalties?

ANSWER Beyond the patents licensed pursuant to terms of the Patent License Agreements discussed above, we expect to act after divestiture in a commercially reasonable manner like any other commercial enterprise, including patent licensing.

15. After the proposed settlement is implemented, will design standards for the network and equipment connected thereto be established by AT&T, or by the BOCs? Specifically, who will set the standards for switched network services? For private line services? For digital services?

ANSWER With respect to network and service standards, AT&T will design for its operations and activities. We would expect that other intercity carriers, as well as the BOCs, will design for theirs. We would also expect that existing coordinating mechanisms such as USITA committees which have helped establish standards for network interconnection, will continue to serve that function.

With respect to "equipment connected thereto", the marketplace will determine what equipment is to be designed and used.

16. Under the proposed settlement, AT&T will retain its control of the network and its dominance of the terminal equipment market.

ANSWER The premises of the question are wrong. First, AT&T does not have "dominance" over the terminal equipment market. In fact, it's one of the most hotly competitive telecommunications marketplaces today. Competitors now win out 50 percent of the time in head-to-head PBX competition with AT&T - and half of the wins go to foreign companies. In Key Telephone Systems competitors win 70 percent of the time - and, again half the losses are to foreign companies.

Second, as to the network, many competing organizations are building alternative facilities using terrestrial microwave and satellites in direct competition with the telephone industry. By and large these facilities totally bypass AT&T's interexchange network.

With more satellites under construction and scheduled for launching in the next few years, and improved technology, this country's domestic satellite channel capacity will increase by 1986 to over one million equivalent voice channels--more than double the total Bell System long distance network capacity today. Bell will own only a small fraction of the 1986 satellite capacity.

Also a factor in the total long distance market are privately owned microwave systems. Today they number over 1,500, spanning over a quarter of a million route miles - a network more extensive than the Bell System's.

16. (continued) If AT&T designs the network or terminal equipment around a patent that it has no obligation to license, do you believe independent manufacturers will be hindered in their ability to manufacture equivalent or compatible equipment?

ANSWER AT&T does not "design the network" "around a patent." In fact, it is in our interest to have the widest possible use of network services consistent with sound network engineering practices. As to terminal equipment, the market is highly competitive, filled with high-technology domestic and foreign competitors. Consequently, AT&T should be able to design and patent freely and protect its patents and technology just as all of its competitors will be doing.

17. What are AT&T's intentions concerning the consolidation of control over SNET and CBI and the purchase of independent telephone companies?

ANSWER AT&T presently owns approximately 21% of the stock of SNET and 31% of the stock of CBI. There is no intention to acquire any additional stock in those companies nor does AT&T plan to purchase any of the other independent telephone companies.

18. What are the intentions of AT&T with respect to entering the digital termination systems and cellular radio markets?

ANSWER AT&T plans to expand its capabilities for digital transmission of information as quickly as is technologically and economically feasible.

With respect to cellular radio, AT&T plans to provide systems and equipment to the Bell Operating Companies and perhaps to other organizations. The local operating companies plan to offer cellular exchange services.

19. Since the BOCs will be restricted to the provision of access lines or access service from the customer premises of AT&T switching locations for connection to AT&T's interexchange services, will decisions as to what equipment will be located on the customers' premises and connected to such services be made by AT&T or by the BOCs?

ANSWER Essentially, the location of equipment on the customer premises is the customer's decision. Obviously, whichever company--the local operating company or any other company--directly terminates a service on the customer's premises may have need for equipment to be located on the premises. Under the Modification of Final Judgment, the local BOC can locate equipment on the customer's premises that is necessary to terminate its local exchange or exchange access services.

19. (continued) Will it be AT&T or the BOCs that provides any telephone company-provided equipment at the customers' premises for connection to the access lines? To AT&T's services?

ANSWER As a general matter, if AT&T equipment must be placed on a customer's premises to terminate an AT&T service on the premises, AT&T would do so. The same would be true of BOC equipment for services provided by the BOCs.

20. Will the BOCs be participating with AT&T in the provision of joint services (where the BOCs provide the local access) or will they merely be providing access to those AT&T-provided services?

ANSWER The modified Final Judgment requires the BOCs, assuming that they are at the ends of an AT&T-provided interexchange call, to file tariffs for access at each end as discrete and separate elements. The regulators, whose jurisdiction is essentially unchanged by the Modified Final Judgment, will determine whether and how "joint services" will be provided.

20. (continued) Will independent telephone companies cease to provide joint services and instead provide access service?

ANSWER The Modified Final Judgment does not govern the independent telephone companies. The question of whether independents will provide services should be directed to them. As Bell System plans to comply with the Modified Final Judgment evolve, we will work with the independent telephone companies with respect to the matters in which they have an interest.

20. (continued) What will be the consequences of such a change for the provision of customer-premises equipment?

ANSWER None, except the withdrawal of customer premises equipment from the base for determining separations and settlements, an issue which is not part of the Modification of Final Judgment, but which the FCC is currently dealing with in Docket No. 20981.

UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF COLUMBIA

UNITED STATES OF AMERICA, Plaintiff, v. AMERICAN TELEPHONE AND TELEGRAPH COMPANY; WESTERN ELECTRIC COMPANY, INC.; AND BELL TELEPHONE LABORATORIES, INC., Defendants.	Civil Action No. 74-1698
UNITED STATES OF AMERICA, Plaintiff, v. WESTERN ELECTRIC COMPANY, INC., AND AMERICAN TELEPHONE AND TELEGRAPH COMPANY, Defendants.	Civil Action No. 82-0192
UNITED STATES OF AMERICA, Plaintiff, v. AMERICAN TELEPHONE AND TELEGRAPH COMPANY, et al., Defendants.	Misc. No. 82-0025 (PI)

SUPPLEMENTAL COMMENTS OF THE STATE OF ARIZONA ON PROPOSED SETTLEMENT

I. INTRODUCTION

The Attorney General of the State of Arizona, on behalf of the State and the Arizona Corporation Commission, the state's constitutionally established public utility commission, files these supplemental comments[1] as authorized by the Court's order of January 21, 1982. In that order, the Court imposed the substantive procedures of the Tunney Act, 15 U.S.C. § 16(b)-(h), with respect to the settlement of the Department of Justice's (Justice) antitrust case against the American Telephone and Telegraph Company (AT&T).[2] Justice and the defendants, AT&T and associated companies, signed a stipulation for voluntary dismissal, thus seeking to terminate one of the most important cases in the history of antitrust enforcement. The effect of this action is to assure that AT&T will be able to retain its Long Lines Department as well as Western Electric and Bell Laboratories within the same corporate family. Simultaneously, the parties agreed to vacate the terms of an existing consent decree in the District of New Jersey, United States v. Western Electric Company, et al., (Western Electric) which had been in effect since 1956, thereby removing previously negotiated restrictions on the activities that AT&T and its affiliates and subsidiaries may engage in.

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[1] Arizona has also filed this day with the Court Joint Comments on behalf of Arizona and other states.

[2] The Court imposed the substantive provisions of the Tunney Act "in response to the request of the parties, in the exercise of the Court's equitable powers, Order at pp. 2-3, and in order that the public interest proceedings be conducted in a concrete framework and pursuant to an orderly, well-defined procedure, . . ."

Under the agreement those provisions are replaced with a modification of the Western Electric Consent Decree (Decree), requiring AT&T to divest its local telephone operating companies. The new Decree imposes broad restrictions on the to-be-divested local companies. Among other things, they will be prohibited from competing with AT&T in providing long-distance or interstate telephone service, in data processing and related information services, in manufacturing or providing telephone equipment or other telecommunication products, and even in the directory advertising business. The Decree also forbids the local operating companies after divestiture to ever engage in any non-telephone business "that is not a natural monopoly service actually regulated by tariff."

The proposed restructuring, in essence, reorganizes the relationships between AT&T and twenty-two of the twenty-four Bell Operating Companies (BOCs). Additionally, it will impact some 1,500 independent telephone companies. In so doing, the proposed Decree attempts to surpass the bounds of a conventional federal antitrust settlement, and may, in fact, impact state and federal regulatory commissions' jurisdictions, thereby leaving more issues unsettled than resolved.

The State of Arizona supports the efforts by Justice and AT&T to resolve their antitrust lawsuit by means of the proposed Decree. We believe that the Decree provisions may provide for removing barriers to effective competition in the telecommunications industry, and still preserve the national public policy of providing universal telephone service at affordable rates.

Our basic conclusion is that the Decree has merit; however, in order for the Decree to achieve success it will require close coordination and cooperation by Justice and the various states who are charged under current law with regulating telephone services which will be impacted by the Decree. In addition, the Decree will require clarification of certain terms and procedures.

We believe that it is necessary for the states to play an essential role in the formulation and implementation of the divestiture and restructuring process which is contemplated by the Decree, including BOC asset valuation and capitalization, exchange boundaries and exchange access charges. In this way, the states can assure that the resulting BOCs will be able to provide quality phone service at reasonable rates and thereby comply with their regulatory mandate as set forth in state law and supported by federal law.

Finally, we believe that Arizona along with the other states, in partnership with the parties to the lawsuit and the Federal Communications Commission (FCC), can effectively resolve any problems and fashion a workable plan for the divestiture and restructuring of the telecommunications industry which will provide for increased competition and enable local telephone companies to provide basic telephone service at reasonable rates.

The following comments explore in greater detail the concerns which Arizona has with respect to the proposed Decree.

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II. INTEREST OF THE STATE OF ARIZONA

The proposed settlement will directly, or indirectly, impact upon telecommunications services provided to every residential and business subscriber in Arizona, as well as every actual or potential competitor in providing telecommunications services to the consumers in Arizona. Therefore, Arizona has a variety of legitimate concerns about the substance of the settlement and the process by which it will be reviewed and ratified by the Court.

Arizona regulates the telephone industry through the Arizona Corporation Commission ("ACC"). Under its constitutional authority,[3/] additional authority given to it by state statute,[4/] and authority pursuant to the 1934 Communications Act,[5/] the ACC regulates all telephone service, and the companies providing such service within the state. This authority parallels the FCC's authority, but is primarily limited to intrastate activities.

Arizona believes that the Decree does not in any way change the regulatory schemes of Arizona and the other states which presently govern intrastate telecommunication services and the companies offering those services. Furthermore, Arizona believes that the Decree does not in any way change the regulatory jurisdictions granted to Arizona and the other states under the 1934 Communications Act.

[3/] Arizona Constitution, Art. XV.

[4/] Ariz. Rev. Stat. Ann., § 40-251, et seq. (1982).

[5/] 47 U.S.C. §§ 152, 221 and 224.

Additionally, the Attorney General has well recognized common law and statutory parens patriae responsibilities to protect the general economy of the state and the economic welfare of its citizens by enforcement of the federal antitrust laws. Georgia v. The Pennsylvania Railroad Company, 374 U.S. 439 1943, Burch v. Goodyear Tire & Rubber Company, 554 F.2d 633 (4th Cir. 1975), and 15 U.S.C. § 15(c). In this capacity, the Attorney General is concerned with the effects the Decree may have on its citizens, consumers and competition generally within the State of Arizona.

Accordingly, this comment underscores a serious defect in the proposed Decree: the proposed modification fails to explicitly incorporate the state regulatory system in the divestiture and restructuring process established.[6/] As a result, the numerous pro-competitive benefits sought to be achieved through the modification may be seriously undermined. This inherent defect exists because the Arizona Corporation Commission has the sole responsibility of ensuring consumers universal, efficient and economical intrastate telephone service, and is empowered by the state Constitution and the state legislature to act to protect those interests, notwithstanding the terms of any consent decree entered by the Court. If the ACC comes to believe that the proposed decree compromises its ability to carry out its regulatory responsibilities, thereby leaving Arizona consumers vulnerable to

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[6/] The proposed modification similarly fails to explicitly incorporate the federal regulatory system.

breaks in service or unnecessarily higher telephone bills, it can exercise its power to prevent the divestiture, restructuring or implementation of the various injunctive provisions contemplated by the parties within the State of Arizona.

Therefore, a consent decree that fails to adequately consider the interest, needs and responsibilities of Arizona and other states raises the spector of state-federal conflict, prevents the Court from conducting these public interest proceedings "in a concrete framework and pursuant to an orderly, well-defined procedure," and may disrupt the ability of Justice and AT&T to carry out the terms of their settlement agreement in a uniform and coordinated manner.

III. GENERAL COMMENTS REGARDING PROPOSED CONSENT DECREE

Our overriding concern with the Decree is that it may adversely affect the quality and the cost of basic telephone service within the state. While we applaud the efforts of Justice to bring about structural changes to what has basically been a regulated and monopolistic environment, the Decree stems from an antitrust foundation and not a public interest standard as embodied in the Arizona Constitution and related statutes and the Communications Act of 1934. Therefore, certain provisions of the Decree will safeguard against future monopolistic activities of local telephone companies, essentially a good provision from the perspective of antitrust; however, these same safeguards may adversely affect the ability of the local telephone companies to provide basic telephone service at reasonable rates.

. . .

A. Concept of the Settlement

Unlike other Federal initiatives, the Decree attempts to inject competition by changing the structure of the basic telephone industry and imposing constraints on the future operations of the local telephone companies. [7]

What the Decree attempts to do is to divide the telecommunications industry into two separate parts: the regulated, or natural monopoly portion, and the unregulated or competitive portion. Conceptually, any portion of the telecommunications industry which currently is capable of competition, or potentially capable of competition, should be deregulated; whereas, any portion of the industry where competition simply will not work should be given natural monopoly status and be regulated by the appropriate jurisdictional body.

Implementing this approach, Justice proposes, and AT&T agrees, to sever from AT&T the source of its monopoly power: the local telephone operating companies. The local telephone companies will be restricted to providing local telephone service and access to its system and customers by any company wishing to provide telecommunications or information services. AT&T, on the other hand, would keep its other subsidiaries, Long Lines division, Bell Laboratories and Western Electric and would be free to enter into any competitive telecommunications services.[8/] Long distance telecommunications has been considered a competitive product for the last few years and will continue to be so. As such, the 22 local telephone operating companies will be precluded from offering interexchange services.

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[7] Justice contends that AT&T's ownership of local telephone exchange monopolies gave it the incentive and ability to monopolize non-regulated, competitive activities (long lines, customer premises equipment, and others) by controlling access to its local exchange monopoly and by "cross-subsidization" of its competitive business with excessive profits from its regulated monopoly business. CIS at 10-16. AT&T's alleged cross-subsidization permitted it to offer goods and services at prices below those which competitors could offer, permitting it to maintain its monopoly in a telecommunications market. CIS at 13.

The proposed divestiture seeks to eliminate AT&T's incentive and ability to use its control of local exchange companies to monopolize potentially competitive long distance, CPE and terminal equipment markets. Divestiture is to be accomplished by a separation of the assets, debt and personnel of twenty-two of the twenty-four existing Bell Operating Companies from AT&T. AT&T is required to divest "sufficient facilities, personnel, systems and rights to technical information to permit" the resulting local exchange companies to provide regulated exchange service.

More specifically, under the Decree decisions are made as to which products are competitive and which products are not. Additionally, the Decree would change the current "separations and settlement" procedures and require the to-be-divested local bell operating companies to charge customers and companies to whom they grant access based on actual use of its telephone services; the Decree will establish a new system of local exchange areas and require a new system of exchange access charges; the Decree goes far beyond legislative and FCC

[8/] Under the Decree, AT&T will not have to divest its minority ownership of its Cincinnati and Southern New England telephone companies. Moreover, these companies will not be subject to the operating restrictions imposed on the 22 other Bell operating companies. Justice has not explained to our satisfaction why these two BOCs should be permitted to engage in the very activities which were at the heart of the 1974 complaint. This raises the general concern of whether the Decree should be limited to requiring divestiture, but not restricting the future activities of the 22 BOCs.

attempts to provide a mechanism to allow AT&T to compete in manufacturing, supplying customer premises equipment and offering information services, and it restricts BOCs from all those fields and limits them to exchange service and "natural monopoly service actually regulated by tariff" (restrictions which are tighter than the 1956 Decree was on AT&T and perhaps unnecessary to accomplish Justice's objectives and goals); and the Decree is limited to twenty-two of AT&T's operating companies. It will not affect any of the 1,500 independent telephone companies nor would it affect Cincinnati Bell and Southern New England Bell in which AT&T only has a minority interest.

Therefore, absent any changes in federal regulation, the Decree imposes a separate system of regulation exclusively for the Bell system. Finally, because the Decree does not change current regulatory authority nor does it bind other than AT&T and the Department of Justice, there are serious concerns raised as to how the various regulatory bodies will treat the changes proposed by the Decree.

B. Scope of Inquiry

The Court has instituted settlement review procedures which closely follow those provided by the Antitrust Procedures and Penalties Act, 15 U.S.C. § 16b-h (the "Tunney Act"). However, whether the review undertaken by this Court is prescribed by the directives of the Tunney Act, 15 U.S.C. § 16e, or simply controlled by the equitable principles applied in judicial consideration of proposed antitrust consent decrees, the test is the same. The Court has to evaluate the proposed settlement in light of the public interest. See United States v. National Broadcasting Company, Inc., 449 F.Supp. 1127 (C.D.Cal. 1978).

In view of the similarity between the issues sought to be addressed by the Decree and the issues traditionally addressed by state public utility commissions (PUCs) and the FCC, we submit that the inquiry here requires the Court to consider the public interest not only as it is embodied under the antitrust laws, but also as mandated by applicable state and federal public utility laws and regulations. Therefore, given the existing regulatory environment, the Court should consider not only the claimed competitive benefits of the proposed restructuring, but also whether those benefits will likely be produced by the settlement unless accommodation to the state and federal regulatory processes is provided.

The reorganization of AT&T may permit real competition in many segments of the telecommunications industry. The proposed Decree, however, provides for only Justice to approve the actual AT&T divestiture plan. Justice's concerns, however, appear to be limited to the effect on competition, which represents only one prong of the public interest test which Arizona urges the Court to adopt. Although the modification sets forth general guidelines by which the asset, debt and tax benefit allocations should be made, it leaves to AT&T the critical choices. Absent a procedure for meaningful state regulatory review of the divestiture details, the public interest in effective regulation of the local operating companies significantly will be impaired.

. . .

In addition, the public interest and enforcement of the antitrust laws will not be served if the ACC and other state PUCs become reluctant to permit the asset transfers required by the settlement. Consequently, in order to ensure that the proposed Decree is in the public interest, this Court must reserve ultimate approval of the actual divestiture plan formulated by the parties while affording state regulatory authorities the opportunity to review and comment upon that plan and initiate whatever local proceedings are required to adopt and implement the provisions of that plan. To accomplish this review effectively, the Court should set forth specific principles for the parties to employ in presenting their divestiture proposal.

C. State Regulatory Concerns Must be a Part of the Settlement

Although Arizona believes that the proposed settlement has merit, it is seriously deficient because it perceives the telecommunications industry only in terms of antitrust theory and excludes a vital element from the contemplated divestiture process: traditional state regulation of intrastate telecommunications.

It has long been recognized in Arizona that the local exchange telephone network could not be efficiently operated under a competitive system. In fact, Arizona has been firmly committed to the doctrine of regulated monopoly in the area of telephone common carriers. Past history has shown that competition in public service enterprises may result in injury to the public, as opposed to benefiting the public, and that such utilities are best conducted under a system of legalized and regulated monopoly. See Arizona Corporation Commission v. Superior Court, 105 Ariz. 56, 459 F.2d 489 (1969). In the interest of technical efficiency and productivity, the ACC intends to maintain the regulated monopoly status of the activities of the local exchange companies, where it believes competition to be harmful to the public interest, as the means upon which it can fulfill its mandate of assuring that universal, efficient, quality telephone service is available at reasonable rates.[9/] Central to the performance of these functions is the existence of local exchange companies which have sufficient authority, assets and personnel to provide universal telephone service.

Any divestiture approved by this Court which attempts to re-allocate the assets and personnel of the BOCs will directly affect the ability of the ACC and other state PUCs to carry out their functions. The ACC is charged by the State Constitution and by state statutes with prescribing a reasonable return to the telephone companies upon the fair value of the company's property used in rendering service to the public. Arizona Constitution, Art. XV, §§ 3, 14; and Ariz. Rev. Stat. Ann. § 40-250 and § 40-251. Consequently, the assets used by the local operating company in providing regulated service are the foundation of rate calculations.

[9/] The FCC, by contrast, is charged with assuring that universal, efficient, quality interstate and foreign telephone service is available at reasonable rates. 47 U.S.C. § 151.

A necessary part of the divestiture called for by the proposed Decree is the fair allocation and evaluation of assets and related debt and tax benefits or liabilities. Current accounting methods employed by AT&T are inadequate for this purpose and have been criticized by many knowledgable sources.[10] In order to ensure both a rational reorganization plan and equitable rate-making after divestiture, this Court must require that the re-allocation be carried out according to responsible accounting principles approved by the ACC and other state PUCs.

The ACC and other state public utility commissions are created by state constitutions or state statutes which clearly empower them to control transfer of assets, and the functions of, or discontinuance of services by, regulated utility companies. See Arizona Constitution, Art. XV and Ariz. Rev. Stat. Ann. § 40-101 et seq. The clearly articulated and affirmatively expressed state policy requiring ACC regulation of local telephone service is not preempted by the Sherman Act. Parker v. Brown, 317 U.S. 341 (1943). See Community Communications, Inc. v. City of Boulder, Colorado, 102 S.Ct. 835 (1982); California Retail Liquor Dealers Association v. Midcal Aluminum, Inc., 445 U.S. 97 (1978); and Cantor v. Detroit Edison Co., 428 U.S. 579 (1976). In Parker v. Brown, a California statute authorizing a state agency to regulate and set rates for that state's raisin industry was held not to conflict with federal antitrust law. The Court, relying upon principles of federalism, explained:

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[10] See, generally U.S. General Accounting Office, Report to Congress "Legislative and Regulatory Actions Needed to Deal With a Changing Domestic Telecommunications Industry," September 24, 1981.

> We find nothing in the language of the Sherman Act or in its history which suggests that its purpose was to restrain a state or its officers or agents from activities directed by its legislature. In a dual system of government in which, under the Constitution, the states are sovereign, save only as Congress may constitutionally subtract from their authority, an unexpressed purpose to nullify a state's control over its officers and agents is not likely to be attributed to Congress.
>
> The Sherman Act makes no mention of the state as such, and gives no hint that it was intended to restrain state action or official action directed by a state.

Parker, 317 U.S. at 350,351. Consequently, nothing in a Decree entered under the authority of the Sherman Act can preempt or supplant ACC regulatory authority.

In short, the state action immunity possessed by the ACC, and other PUCs, effectively vests them with the power to veto many of the crucial steps of the settlement insofar as they occur within their respective jurisdictions. For example, acting pursuant to its authority to approve or disapprove transfers of regulated functions or assets, the ACC could decline to permit a BOC to transfer to AT&T assets, such as customer premises equipment. Indeed, it is probable that state commissions may, acting pursuant to their constitutional and statutory authority, require local exchange companies to continue to offer customer premises equipment, provide a classified directory (yellow pages), or provide other intra-exchange and interexchange services. Moreover, the ACC could veto the exchange area plan proposed by the parties and require the regulated telephone company to serve all points within a larger or different calling area; veto the exchange access charges established by the parties; and could revoke the to-be-divested BOC's certificate of convenience and necessity to operate within the state, because it no longer is deemed to be fit, proper, or capable of providing monopoly services in a manner consistent with Arizona law.

The power thus possessed by the ACC and other PUCs pursuant to the state action immunity doctrine could, if exercised by some and not by others, result in a fragmented and balkanized scheme of telecommunications services and effectively frustrate the laudable intent of the proposed settlement. Accordingly, it is critical that the proposed modification recognize the power and responsibility of the states and provide a meaningful role for the states in the reorganization process. The "consultative" role suggested by Justice in its Competitive Impact Statement (CIS at 18) is clearly not sufficient.

Therefore, the proposed reorganization of AT&T must be governed by specific principles to guarantee that, as the antitrust concerns of the settlement are carried out, the regulatory needs of the state are also met.

D. Request for Changes in Public Interest Procedures

Arizona shares the concerns of those states and other entities which previously have filed motions to formally intervene and requests that the Court appoint counsel in the nature of a guardian *ad litem*, an independent expert to advise on the implications of the proposed settlement on residential and business users, and a request that a Federal State Joint Board be appointed as a special master to the Court. Nevertheless, Arizona agrees with the Court that "there is no absolute right to intervene" and "no purpose would be served by allowing intervention" prior to submission of the April 20, 1982 comments and receipt by the Court of Justice's responses. As the Court stated in its March 24, 1982 order denying requests for intervention and suggestions:

> When all the comments and the Department of Justice's responses are received by the court approximately forty days from now, and depending upon the substantive content of these comments and responses, there will be time enough to consider what procedures will best effectuate the public interest with respect to the settlement proposal; what status, including that of intervenors, should be accorded to those who have objections to approval of the settlement by the Court; and what representatives, if any, may need to be appointed to protect the interest of persons or entities not otherwise represented, or what special masters, if any, should be designated to assist the Court in further proceedings.

In that same order, the Court recognized the problems created by affording intervenor status during the comment filing and review process. The Court stated:

> The participation of large numbers of interested persons, entities, and groups at the judicial level while the comments are being filed with and responded to by the Department of Justice would add enormous procedural complications to this case without affording either substantive protection to such applications or assistance to the Court. To the extent that any such person, entity, or group may believe that its legitimate concerns are not met by the Department of Justice's responses to the comments, it may, of course, submit appropriate substantive and procedural

> proposals to the Court after those responses are filed. The Court intends to afford appropriate opportunities for such filings.

Acknowledging the Court's intentions to accommodate Arizona and other interested entities after completion of the comment review, Arizona offers to the Court suggestions on how the Court "will establish a concrete framework for participation in these proceedings as contemplated in paragraph 10 of the January 21 order," and how it will determine "what status for persons or entities who object to the settlement proposal will best effectuate the Tunney Act purposes." Memorandum of Court, dated February 5, 1982 at footnote 4.

Given the interest and concerns by state PUCs and the FCC in the telecommunications issues addressed by the proposed Decree, given the fundamental regulatory roles of the state PUCs and the FCC, and given the roles of the various states attorneys general to protect the general economy of their states and the economic welfare of their citizens by enforcement of the federal antitrust laws, Arizona suggests that the Court consider granting to the states and the FCC intervenor status. First, since these bodies will most likely be dealing with the same issues in coterminous proceedings[11/], the

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[11/] The Arizona Corporation Commission will soon commence formal docket proceedings to officially monitor the conduct of Mountain Bell and AT&T prior to and throughout the Consent Decree proceedings; and to enable the Commission to exercise its legitimate regulatory jurisdiction over issues before the Court which may affect Mountain Bell, AT&T, the independent telephone companies operating within Arizona, actual and potential competitors of telecommunication services in Arizona, and the consumers of telecommunication services within the State of Arizona.

Court will be in a better position to monitor those independent proceedings as well as work with those parties to realistically fashion and implement relief which would not be inconsistent with state regulation, pursuant to state law and the 1934 Communications Act, and the orders of the FCC, pursuant to the 1934 Communications Act. Second, by limiting the number of intervenors to the states and the FCC, subsequent public interest review proceedings will be more manageable than allowing every person or entity who object to the settlement proposal to intervene.

Moreover, the states and the FCC will be able to interface with, and protect the interests of, the various groups, entities and other persons who will be impacted by the Decree within their respective jurisdictional areas. This should serve to minimize the burdens placed on the Court, AT&T and Justice by granting to additional entities party status in connection with the settlement proceedings. Finally, by limiting intervenors to the states and the FCC it will be less likely that the Court will inadvertently establish telecommunications policy, which role properly belongs to the states, the Congress and the FCC.

Arizona also suggests that the Court retain continuing jurisdiction over the restructuring and divestiture, and the implementation thereof, so that it may approve or reject subsequent implementation steps. In this connection, we also urge the Court to establish periodic review of the Decree, including comment and participation by interested persons, to ensure that the Decree remains in the public interest and does not become outdated or obsolete by technology, as did the original 1956 Decree.

IV. PRIMARY CONCERNS WITH PROVISIONS IN PROPOSED DECREE

What follows is a summary of our primary concerns with the proposed Decree. These concerns, as distinguished from our secondary concerns (*infra* at V), specifically relate to whether the form of divestiture proposed in the Decree is in the public interest as it relates to the State of Arizona. Many of the problems enumerated below could be dealt with by amending the Decree itself.

1. PREEMPTION

Despite the fact that the language in the Decree would appear to preempt inconsistent state statutes, Justice contends that the Decree is not intended to alter any present regulatory jurisdiction, be it state or federal. Nevertheless, there is a significant amount of uncertainty and ambiguity as to how the structural changes proposed by the Decree will be implemented and who will be charged with overseeing said changes. There is a need for certainty as to the states' role under the agreement.

At a minimum, because of Arizona's significant and historical interest and jurisdictional role in providing basic telephone services to its citizens, Arizona urges the Court to adopt a bifurcated public comment period procedure; specifically, assuming the Court ultimately enters the Decree, it should require an additional comment period following AT&T's submission of a plan for divestiture and reorganization of its operations (required 6 months after entry of the Decree). In this way, the states are guaranteed a further opportunity to review and provide input on how the local bell operating companies will be divested and the impact on local telephone rates caused by the divestiture.

Additionally, since the Decree would permit or require corporate and regulatory changes which are subject to the jurisdiction of the ACC and the FCC, we urge the Court to require insertion of a Terminal Railroad[12/] type provision acknowledging that nothing in the Decree shall affect in any manner or at any time the regulatory powers of the ACC and the FCC over actions within their respective jurisdictions.

2. DIVESTITURE OF THE BELL OPERATING COMPANIES (BOCs)

Perhaps the most significant problem created by the Decree is what the to-be-divested bell operating companies will look like. Under the Decree, AT&T and Justice will decide which assets to transfer, which debt to transfer, what amount of capitol to transfer as well as the valuation of assets, debt and capitol. What is transferred and how it is valued will determine whether or not the BOC will be financially

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[12/] United States v. Terminal Railroad Association, 236 U.S. 194 (1915) and Terminal Railroad Association v. United States, 266 U.S. 17 (1924). Paragraph 6 of the final antitrust decree stated as follows:

> Nothing in this decree shall be taken to affect in any wise or at any time the power of the Interstate Commerce Commission over the rates to be charged by the Terminal Railroad Association, or the mode of billing traffic passing over its lines, or the establishing of joint through rates or routes over its lines, or any other power conferred by law upon such commission.

viable and therefore, able to provide local telephone service at reasonable rates and access to interexchange carriers for other telecommunications services.

Asset assignment and valuation also is critical because the resolution of this issue must take into account the size of the exchange areas which the local exchange company will serve, and how exchange access charges will be established since these charges are intended to replace the current separations procedure. Each issue drives the others and their resolution will determine the structure and operation of the telecommunications industry in the State of Arizona.

There are no guidelines for determining the financial condition of a BOC upon divestiture and no provision for BOC or regulatory input in the reorganization planning process. Further, no mechanism is specified or referenced in establishing the value of assets to be transferred from BOCs to AT&T. Book value is the implied standard and this standard may substantially understate the value of CPE and interexchange equipment leaving BOC consumers with unfairly high costs.

While several proposals have been offered on how to accomplish this process,[13] it is clear that the states should have a principal role in this process within the context of the Decree since the ACC, and other PUCs, will play a significant role in any divestiture in connection with coterminous state proceedings.

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[13] Some states favor a spin-off of the BOCs intact, followed by asset valuation and transfer of assets from the BOCs to AT&T; other states, including Arizona, are considering the establishment of a new BOC first, followed by the valuation and transfer only of those assets necessary for the new BOC to remain financially and operationally viable. As to the cost accounting method to be adopted in the valuation process, Arizona is considering several, including fully distributed costs (FDC) accounting methodology.

3. EXCHANGE ACCESS

Under the Decree, the BOCs must provide access to its exchange facilities to all companies offering competitive telecommunications services directly to consumers on an unbundled, tarrifed basis that does not discriminate against any company or other customer and must be cost justified. This system will replace the present division of revenues process of "separations and settlements". The Decree is unclear on what methodology the parties will use to arrive at a system of access charges and what governmental entity will establish access charges.

In this connection, once the BOCs are divested from AT&T, they will no longer be common carriers (interstate telephone companies) and therefore, will be subject to limited FCC jurisdiction. Since access to an exchange basically is the same whether access is being sought by a company inside the state or by a company located outside the state, we believe that the state ultimately will be responsible for the setting of exchange access rates for intrastate and interstate business.

Arizona urges the Court to defer to the ACC and other state PUCs jurisdiction over all local exchange costs and access charges, including charges to interstate carriers. This approach is consistent with the Decree's requirement that charges for access to and usage of local exchange networks be non-discriminatory among competing interexchange carriers, whether intrastate or interstate. Since each of the respective states will have a different make up of local exchange companies with different revenue requirements and different exchange areas to serve, a system of nationwide, uniform access charges and a pooling of access revenues, as contemplated by the FCC in Docket 78-72, would be inconsistent with the Decree and may promote economic inefficiency and distort the market for competitive alternatives to local exchange facilities.

4. EXCHANGE BOUNDARIES

Under the Decree, the parties will establish the divisions within each state for exchange areas. That is, the parties will decide the geographical boundaries of each and every local telephone exchange area. In so doing, the parties will determine which phone calls will be local or intra-exchange, and which phone calls will be long distance, or interexchange. This will impact the cost or charges for providing local exchange service, the cost charged for exchange access, and which types of telephone equipment the BOC must have in order to provide service within the exchange area and provide access to its exchange facilities.

Again, because of the relationship between divestiture, exchange access and exchange boundaries, and because of the many regional and geographic variations among the states[14/], Arizona and the other states will have to play a major role in this process.

[14/] For example, Arizona has a unique make-up of high density and low density areas.

5. TRANSITION PERIODS

Unlike other federal approaches to telecommunications issues, the Decree does not provide for any transition period from a regulated environment to an unregulated environment for telephone equipment, including customer premises equipment, yellow pages, etc. Justice contends that transition periods are not necessary because presently there are competitors, or potential competitors, with the capacity necessary to enter these marketplaces. While, from an antitrust point of view, Justice may be correct, such an abrupt change and loss of revenues to the BOCs in the short run may have a serious impact not only on the financial viability of the BOC, but on the affordability of basic telephone service by consumers. For example, it may preclude customers from availing themselves of other options (purchase of in-place telephone equipment), or preclude customers from reassessing current long-term contractual arrangements with AT&T regarding the sale or lease of telephone systems whose validity may become suspect in view of the divestiture and restructuring of AT&T.

Arizona will exercise its regulatory authority to require transition periods where necessary to protect the public interest, and we urge the Court to similarly consider such transition periods where necessary.

6. VIABILITY OF THE LOCAL BOCs and IMPACT ON LOCAL EXCHANGE RATES

The objective of the Decree is to remove from AT&T the structural source of its monopoly power: ownership and control over the local operating company. The Decree accomplishes this by requiring divestiture of twenty-two Bell operating companies. However, the Decree then departs from consistency and antitrust logic and imposes significant restrictions on what activities the BOC may engage in after divestiture, but allows AT&T to keep its ownership interest in Cincinnati Bell and Southern New England Bell without subjecting those companies to the restrictions imposed on the other BOCs. Moreover, the Decree has no effect on independent telephone companies' abilities to engage in integrated regulated and unregulated activities.

Restrictions on the operations of the BOCs will remove a number of very profitable activities, including yellow pages advertising, and the sales and rentals of customers telephone equipment. These profitable services have enabled the BOCs to keep local telephone rates lower than they might otherwise be. While price decreases and new innovations may result in the competitive areas of telecommunications equipment, customer premises equipment, yellow pages, and other interexchange and information services, these benefits might extract too high of a cost to local telephone subscribers.

Moreover, if the intent of the Decree is to promote competition then it is unclear why local telephone companies who have long provided equipment and interexchange services should be excluded from entering these or other competitive telecommunications or information service fields either through separate subsidiaries, or even when integrated into the operations of the exchange corporation provided there are appropriate accounting safeguards. It is clear that such opportunities would not only promote further competition, but it might dampen and prevent market domination by the surviving AT&T corporation, especially in the interexchange markets. And it might permit the BOCs to continue to grow, as opposed to remaining static, in the exploding telecommunications industry and avoid the problems inherent in the 1956 Consent Decree which prevented AT&T from offering to the public technological innovations, new services and lower prices.

Of particular interest to Arizona is the provision in the Decree that allows the BOC to offer telephone equipment only for emergency services. According to Justice, the emergency services exception is confined to disaster situations and the emergency restoration of interrupted services or repair equipment in a time frame in which it is not feasable to make arrangements with competitive providers of telephone equipment. In addition, this provision would allow the BOC to provide telephone equipment to the military or public safety agencies where the independent supply of such equipment is not practical. This emergency exception is much too limited since it would exclude the ability of Mountain Bell to provide enhanced 911 emergency services, telephone equipment for the deaf, and lifeline telephone equipment for the poor and elderly. Furthermore, since the BOC will have to maintain an inventory of equipment for emergencies and the military, etc., and maintain a staff to provide and service this equipment, why not allow the BOC to provide, but not manufacture, and service equipment in the competitive marketplace.

. . .   . .

Other subsidiary issues not covered by the Decree may affect the BOCs and local rates. For example, the Decree is silent on the issue of ownership and operation of coin-operated telephones, the issue of ownership and supplying customer premises wiring, the issue of ownership and operation of private line telephone services, and the issue of telephone system repair service. Arizona will consider these issues and we urge the Court to address these in connection with the Decree proceedings.

Finally, Arizona maintains that the Decree cannot override clearly articulated state regulatory policies which require the BOCs to offer additional services prohibited under the Decree.

V. SECONDARY CONCERNS WITH PROVISIONS IN PROPOSED DECREE

Arizona has secondary concerns with provisions in the Decree and the effect they will have on competition and consumers. While Arizona views these concerns as being significant, on a priority basis they can be addressed after our primary concerns. Additionally, there are a host of technical/operational concerns as well as concealed effects which the Decree will have, but these additional concerns and effects will not surface and take on importance until after the plan for divestiture is submitted to the Court and an implementation procedure is established.

1. PRE-DIVESTITURE/DIVESTITURE

Once the Decree is entered by the Court, then the parties have six months to work out a plan for implementing the divestiture and reorganization, followed by an additional twelve months to implement that plan. The Decree is silent on whether prior to its entry or approval of the divestiture plan AT&T can divest itself of local exchange assets. For example, AT&T may decide that they can get a better price by selling a local telephone company or some of the assets of that company to an independent telephone company since those assets will not be subject to the restrictions under the Decree. This is not speculation since AT&T reportedly is selling off exchange assets in New Mexico. The problems posed by such activity directly relate to the condition of the divested BOC under the Decree since much of the equipment necessary to keep it financially viable may previously have been sold by AT&T; and the regulated BOC may face competition from an unregulated and stronger (since it purchased the BOCs former assets) independent telephone company.

Arizona urges the Court to impose a process for review of AT&T's sale of any exchange assets prior to approval and implementation of the divestiture plan.

2. BY-PASS ISSUES

The Decree is quite specific on what activities the BOCs may engage in after divestiture. However, the Decree is silent on what activities AT&T may engage in which duplicate or compete with services to be provided by the BOCs. For example, the BOCs are prohibited from providing anything but exchange telecommunications services or natural monopoly services actually regulated by tarriff. However, AT&T is free to establish its own system of providing high-usage customers with local exchange telephone services by means of microwave or cellular technology which avoids the use of the BOCs facilities. Since this latter technology may be less expensive than the technology left behind with the BOCs, AT&T could be successful in skimming away the most profitable accounts. Not only would such activities by AT&T affect the financial viability of the BOC, they might result in a small percentage of consumers having to pay higher rates for local telephone services provided by the BOC.

Moreover, since the Decree does not affect the ten independently-owned telephone companies which provide local exchange service in Arizona, MCI, Southern Pacific (SPRINT), or other actual or potential providers of telecommunication services, the BOC may be unable to raise investment and working capital to finance its operations, and its operations may become technologically obsolete within a few years.

If the Court accepts the parties' conceptual framework that the telecommunications industry be divided into regulated and competitive portions, then there should be an express prohibition on unregulated entities providing natural monopoly services as defined by the respective states. Otherwise, there is no reason to impose any operating restrictions on the divested BOCs; an alternative which may be preferable to Arizona.

3. DIRECTORY ADVERTISING

While the Decree is ambiguous regarding directory operations, Justice contends that basic directory operations and the white pages should remain with the BOC; however, yellow page operations or advertising operations should go to AT&T

after the divestiture.[15] The overall directory operation is extremely profitable, with most of the profits coming from the sale of yellow pages advertisements. These profits, in turn, have been used to defray the cost of other services, including basic local telephone service. Loss of these directory profits through divestiture would require offsetting local service rate increases.

Justice believes that the BOCs still will be able to extract the same profits from yellow pages by selling its directory lists to the highest bidder. Unfortunately, Justice fails to recognize that since AT&T will be taking the current contracts for yellow pages, as well as the personnel who have acquired the expertise and knowhow in selling yellow pages, it most likely will be the only bidder for the directory listings. Additionally, it is Justice's contention that anyone can enter into the yellow page business by using old lists or by establishing their own list by contacting businesses directly. Under this scenario, the price which the BOC may be able to extract for its most current directory listings may fall short of the revenues presently received.

In Arizona, the BOC owns all telephone numbers; subscribers have no property right in the number and the BOC can change the telephone number of a subscriber "whenever it considers it desirable in the conduct of its business."[16]

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[15] AT&T has stated that Justice insisted on this provision; it reportedly remains neutral on yellow pages.

[16] See Arizona Corporation Commission, General Exchange Tariff, Section 20, General Regulations, ¶ N.

We understand that telephone numbers and classified advertising are handled differently by the various states. Therefore, this is another area where the Court should defer to the state regulators the determination of whether or not the publication of yellow pages can be performed competitively without increasing local rates to offset lost revenues.

4. RESEARCH AND DEVELOPMENT AND OTHER CONTRACT SERVICES

The Decree will terminate the various contracts between AT&T and the BOCs under which the BOCs have paid AT&T for advice and assistance from AT&T's General Department, and for basic research and systems engineering work performed by Bell Laboratories, the research arm of the Bell System. While the divested BOCs will be free to create a centralized entity which can provide advice and assistance, it is unclear whether they will be able to establish their own research and development operation or under what conditions they can contract with Bell Laboratories to provide research.

Additionally, for a period of five years AT&T will be required to provide to the BOCs Bell Laboratory services on a priority basis. We are concerned, however, that the Decree does not clarify how the twenty-two divested companies will compete for priority basis, and there is no mention of how AT&T will charge for these services.

We are also concerned that there is no provision in the Decree for reimbursing to the BOCs or to local telephone service consumers for the development of telephone exchange and non-exchange related projects and innovations. Most of the patents obtained by AT&T, as well as the products developed by Western Electric, have been supported or subsidized by local telephone service ratepayers. Justice contends that it is unable to devise a way of reimbursing the BOCs or ratepayers for research and development and innovations. According to Justice, it's "water over the dam" and local ratepayers would not get any future benefit from their past contributions for research and development which AT&T now will be free to use without compensation. Justice merely wants to remove research and development from future rate base determinations.

We disagree and feel that the BOCs and the local ratepayers must be compensated for their contribution to AT&T's innovations. This can be done either in the valuation of assets, debts and revenues which will flow into the divested BOC, by a requirement that AT&T continue to license out all current patents, and any patents obtained as a result of ongoing research and development prior to the time of divestiture, to any and all competitors at a reasonable royalty rate for the life of the patents, or by requiring a reduced cost for the additional five years of priority Bell Laboratory services to reflect ratepayer contributions.

5. WESTERN ELECTRIC

Presently, Mountain Bell is dependent upon Western Electric, the manufacturing arm of the Bell system, for millions of dollars in equipment and services each year. Under the Decree, the license contracts which make Mountain Bell a captive purchaser or customer of Western Electric will be terminated. However, in the short run there will be few if any competitors to supply Mountain Bell with new telephone equipment and Mountain Bell probably will have little choice but to purchase Western Electric equipment for repair and expansion of existing equipment previously purchased from Western Electric. Therefore, competitive pressures will not prevent Western Electric from increasing its prices.

Under current regulation, regulators can prevent supra competitive price increases by refusing to pass them on to the ratepayers. After divestiture, however, this profit limiting mechanism will disappear. Therefore, equipment purchase costs actually incurred by Mountain Bell would have to be recognized in the ratepayer base unless competitive products at lower prices were available elsewhere.

This situation is exacerbated if Mountain Bell does not receive adequate assets as part of the divestiture, or if the present assets of Mountain Bell are substantially out-dated and soon will be technologically obsolete. Therefore, Mountain Bell could be at the mercy of the predatory prices of Western Electric.

We suggest that during the five year period in which Western Electric must continue to provide services on a priority basis to the BOCs that Western's profits on sales to the BOCs be limited to current regulated profit levels for that period, or that the period of priority service be extended, and that Western Electric be required to live up to any equipment warranties after divestiture. Additionally, Western Electric should be required to maintain spare parts not only on equipment that has been sold to the BOCs, but on all customer premises equipment for a set period of years to prevent AT&T from imposing technological obsolescence on current equipment.

6. SOVEREIGN NATIONS

Arizona, and a select number of other states, may have the additional problem of the impact of the Decree on the present operations of telephone companies either owned by Indian tribes or located on Indian reservations because of the tribes' status as a sovereign nation. We urge the Court and the parties to address this issue.

VI. RECOMMENDATIONS

These comments, as well as the Joint Comments filed on behalf of Arizona and other states, have expressed numerous concerns with the potential impact of the proposed Decree on Arizona and its consumers. For the reasons previously set forth in these Comments, Arizona recommends that the Court make the following modifications to the proposed settlement:

1. AT&T should not be freed from the injunctive provisions of the 1956 Decree until the divestiture of the BOCs is complete.

2. Since the proposed Decree would permit or require corporate and regulatory changes which are subject to the jurisdiction of the Arizona Corporation Commission and the Federal Communications Commission, we urge the Court to require insertion of a Terminal Railroad type provision acknowledging that nothing in the Decree shall affect in any manner or at any time the regulatory powers of the Arizona Corporation Commission and the Federal Communications Commission over actions within their respective jurisdictions.

3. The Court should retain continuing jurisdiction over the restructuring and divestiture, and the implementation thereof, so that it may approve or reject subsequent implementation steps, and interested persons will have an opportunity to submit comments or otherwise participate in these steps. The Court should also establish periodic reviews of the Decree to ensure that it remains in the public interest and does not become outdated by technology.

4. Given the interest and concerns by state public utility commissions and the Federal Communications Commission in the telecommunications issues addressed by the proposed Decree, given the fundamental regulatory roles of the state public utility commissions and the FCC, and given the roles of the various state attorneys general to protect the general economy of their states and the economic welfare of their citizens by enforcement of the federal antitrust laws, the Court should consider granting to the states and the FCC intervenor status.

5. The Court should grant the states a principal role in the divestiture process.

6. The Court should defer to the state public utility commissions jurisdiction over all local exchange costs and access charges, including charges to interstate carriers.

7. The Court should grant to the states a major role in the establishment of exchange boundaries.

8. The Court should defer to the state public utility commissions and the Federal Communication Commission on any . . .

restrictions to be imposed on providers of telecommunications services, including the BOCs.

9. The Court should impose a process for review of AT&T's sale of any exchange assets prior to approval and implementation of the divestiture plan.

10. The Court should defer to state regulators the determination of whether or not the publication of yellow pages or classified advertising can be performed competitively without increasing local rates to offset lost revenues.

11. The Court should devise a way in which AT&T will compensate the BOCs and local ratepayers for their contribution to AT&T's innovations.

12. The Court should establish guidelines for determining the financial condition of a BOC upon divestiture, provide for BOC or state regulatory input in the reorganization planning process, and establish a mechanism for establishing the value of assets to be transferred from BOCs to AT&T.

13. The Court should establish a procedure whereby AT&T provides to the BOCs for five years various research and development and other license contract services on a priority basis, and the Court should devise a system of charges for these services.

14. The Court should require that during the five-year period in which Western Electric must continue to provide services to the BOCs that its profits be limited to current regulated profit levels for that period, or that the period of priority service be extended, and that Western Electric be required to live up to any equipment warranties after

divestiture. Additionally, Western Electric should be required to maintain spare parts not only on equipment that has been sold to the BOCs, but on all customer premises equipment for a set period of years to prevent AT&T from imposing technological obsolescence on current equipment.

15. The Court and the parties should address the issue of the impact of the proposed Decree on sovereign Indian nations.

16. The Court should consider the establishment of transition periods to facilitate the transition from a regulated environment to an unregulated environment.

VII. CONCLUSION

Although the proposed settlement may enhance competition in the telecommunications industry, it is seriously deficient in its failure to incorporate principles necessary to assure that state regulatory authorities will be able to continue to assure consumers of universal, adequate and economical telephone service. These concerns are vital and can be met only if the Court requires the parties to modify the Decree and structure the divestiture process to accommodate state PUCs and the FCC, and retains jurisdiction to supervise all stages of the reorganization process. Further, the Court must acknowledge the fundamental and necessary role of the states in bringing about any viable competition in the telecommunications industry.

Accordingly, unless and until the Decree is clarified to provide these necessary controls and to incorporate the important principles suggested in this comment, the proposed modification is contrary to the public interest and must be rejected.

RESPECTFULLY SUBMITTED this 20th day of April, 1982.

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IN THE
UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

UNITED STATES OF AMERICA, Plaintiff, v. AMERICAN TELEPHONE AND TELEGRAPH COMPANY; WESTERN ELECTRIC COMPANY, INC.; AND BELL TELEPHONE LABORATORIES, INC., Defendants.	Civil Action No. 74-1698
UNITED STATES OF AMERICA, Plaintiff, v. WESTERN ELECTRIC COMPANY AND AMERICAN TELEPHONE AND TELEGRAPH COMPANY, Defendants.	Civil Action No. 82-0192
UNITED STATES OF AMERICA, Plaintiff, v. AMERICAN TELEPHONE AND TELEGRAPH COMPANY, et al., Defendants.	Misc. No. 82-0025, P.I.

JOINT COMMENT OF THE STATES OF ALABAMA, ARIZONA, ARKANSAS, COLORADO, DELAWARE, KANSAS, LOUISIANA, MAINE, MISSISSIPPI, MONTANA, NEW HAMPSHIRE, OHIO, OKLAHOMA, RHODE ISLAND AND THE PROVIDENCE PLANTATIONS, SOUTH CAROLINA, SOUTH DAKOTA, VERMONT, WEST VIRGINIA, WISCONSIN, THE COMMONWEALTHS OF MASSACHUSETTS, PENNSYLVANIA AND VIRGINIA, THE DISTRICT OF COLUMBIA, THE NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES, THE UTILITY CONSUMER ADVOCATES OF THE STATES OF FLORIDA, GEORGIA, MAINE, MARYLAND, THE COMMONWEALTH OF PENNSYLVANIA AND THE DISTRICT OF COLUMBIA, AND THE PUBLIC UTILITY COMMISSIONS OF ARIZONA, COLORADO, SOUTH DAKOTA, AND THE DISTRICT OF COLUMBIA

This Joint Comment is filed on behalf of the States of Alabama, Arizona, Arkansas, Colorado, Delaware, Kansas, Louisiana, Maine, Mississippi, Missouri, Montana, New Hampshire, Ohio, Oklahoma, Rhode Island and the Providence Plantations, South Carolina, South Dakota, Vermont, West Virginia, Wisconsin, and the Commonwealths of Massachusetts, Pennsylvania and Virginia, by their attorneys general, and on behalf of the District of Columbia by its Corporation Counsel. It is also filed on behalf of the National Association of State Utility Consumer Advocates ("NASUCA") [1] and individually on behalf of the regulated utility consumer advocates of the States of Florida, Georgia, Maine, Maryland, the Commonwealth of Pennsylvania, and the District of Columbia. Further this Comment is filed on behalf of the Public Service Commissions of the District of Columbia and South Dakota, the Public Utilities Commissions of Colorado and Arizona Corporations Commission.

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[1] In addition to joining in this multi-state Comment, separate comments addressing the issues raised here and other issues are being filed by NASUCA, various state's regulated utility consumer advocates and public service commissions.

I.

INTERESTS OF COMMENTORS

The attorneys general, the public utility consumer advocates and regulators participating in this Comment -- who have a duty to protect the public interest -- have joined together to communicate common concerns to the Court about the impact of the proposed modification of the consent decree in United States v. Western Electric Company, Inc., Civ. No. 82-0192 (D.D.C.), and proposed voluntary dismissal of United States v. American Telephone and Telegraph Co., Civ. No. 74-1698 (D.D.C.). The heart of our common concerns is the impact that the proposed modification will have on the cost and quality of telecommunications services for consumers.

State attorneys general have well recognized common law and statutory parens patriae responsibilities to protect the general economy of their States, Georgia v. Pennsylvania Railroad Co., 324 U.S. 439 (1945); Burch v. Goodyear Tire and Rubber Co., 554 F.2d 633 (4th Cir. 1977), and the economic welfare of their citizens by enforcement of the federal antitrust laws. See 15 U.S.C. § 15c; 15 Blackstone Commentaries. Public utility consumer advocates are appointed by State law to represent the utility consumers' interest in particular and the public's interest in general before State public utility commissions and elsewhere. See, e.g., Ala. Code § 37-1-16 (1975); Md. Ann. Code, art. 78, §§ 14-15.

This Joint Comment underscores a serious defect in the proposed settlement: the proposed modification fails to incorporate the state regulatory system in the divestiture process established. As a result, the pro-competitive benefits sought to be achieved through divestiture may be seriously undermined.

This inherent defect in the proposed modification exists because State public utility commissions ("PUCs"), which have the responsibility of ensuring consumers universal, efficient and economical telephone service, are empowered by State law to act to protect those interests, notwithstanding the terms of any consent decree entered in these cases. If the PUCs come to believe that the proposed decree compromises their ability to carry out their important regulatory responsibilities -- leaving consumers vulnerable to deterioration of service or unnecessarily higher telephone bills -- they may be induced to exercise their power to prevent divestiture (or implementation of the injunctive provisions) within their States.

In sum, a decree that fails to consider adequately the needs of State regulation raises the spectre of federal-state conflict, may impair the ability of the parties to carry out a reorganization in a uniform and coordinated manner, and presents the devastating prospect that consumers will be confronted with substantially higher telephone bills.

II.

SCOPE OF INQUIRY

The Court has instituted settlement review procedures which closely follow those provided by the Antitrust Procedures and Penalties Act, 15 U.S.C. § 16b-h (the "Tunney Act"). However, whether the review undertaken by this Court is prescribed by the directives of the Tunney Act, 15 U.S.C. § 16e, or controlled by the equitable principles applied in judicial consideration of proposed antitrust consent decrees, the test is the same. The Court has to evaluate the proposed settlement in light of the public interest. See United States v. National Broadcasting Co., Inc., 449 F. Supp. 1127 (C.D. Cal. 1978). In the instant case, that inquiry requires the Court to consider not only the claimed competitive benefits of the proposed restructuring but also whether those benefits will likely be produced by the settlement unless accommodation of the State regulatory process is provided.

The reorganization of AT&T may permit real competition in many segments of the telecommunications industry.[2/]

[2/] Legitimate concerns can be raised regarding the near term competitive possibilities in the long distance, CPE, and terminal equipment markets where AT&T will continue to hold formidable market shares. See, e.g., United States v. Grinnell Corp., 384 U.S. 563, 571 (1966) (eighty-seven percent market share clearly exceeds the market share required to find monopoly power.) Nevertheless, in theory, this settlement creates the real possibility for enhanced competition over the long term. With adequate Court supervision of the post-divestiture market, the prospects for viable competition improve substantially.

However, the proposed modified decree provides only for the Department of Justice ("DOJ") -- which is apparently concerned only with the effect upon competition -- to approve the actual AT&T divestiture plan. Although the proposed decree sets forth general guidelines by which AT&T assets should be divested, it leaves to AT&T the critical choices in that regard.

Absent a procedure for meaningful State regulatory review of the divestiture details, the public's interest in effective regulation of the local operating companies will be impaired significantly. In addition, the public's interest in enforcement of the antitrust laws will not be served if State PUCs become reluctant to permit the asset transfers required by the settlement. Consequently, in order to ensure that the proposed modification is in the public interest, this Court must reserve ultimate approval of the actual divestiture plan formulated by the parties while affording State regulatory authorities and others the opportunity to review and comment upon that specific plan. At the same time, the Court should prescribe specific criteria which are consistent with the public interest to guide the parties in structuring their divestiture plan. Those criteria are discussed below.

III.

CONCEPT OF THE SETTLEMENT

The proposed settlement seeks to eliminate what the Department of Justice perceives to be the seed from which AT&T's

allegedly illegal conduct grew: the ownership of both regulated natural monopolies (local exchange companies) and competitive businesses (long lines, customer premises equipment, and others). Competitive Impact Statement ("CIS") at 10, 16. The Department contends that AT&T's ownership of local exchange monopolies gave it the incentive and ability to monopolize non-regulated markets through "cross-subsidization" of its competitive business with excessive profits from its regulated monopoly business and by controlling access to the local exchanges. CIS at 10-16. According to DOJ, AT&T's alleged cross-subsidization permitted it to offer goods and services at prices below those which competitors could offer thereby allowing it to maintain its monopoly over the telecommunications market. CIS at 13.

The proposed divestiture seeks to eliminate AT&T's incentive and ability to use its control of local exchange companies to monopolize potentially competitive long distance, CPE and terminal equipment markets. AT&T is required to divest "sufficient facilities, personnel, systems and rights to technical information to permit" the resulting local exchange companies to provide regulated exchange service. Proposed Modification of Final Judgment ("Modification") ¶ IA(1). The function of the resulting local exchange companies [3] will be limited to provision of exchange telecommunications, exchange access service and "natural monopoly services actually regulated by tariff." Modification ¶ II D(3). Functions not deemed to be "natural" monopoly functions are left to the marketplace and may not be provided by local exhange companies. These so-called "competitive services" include transmission of interstate and intrastate interexchange telephone calls, provision of terminal and customer premises equipment, and sales of directory advertising. Modification ¶ II D.

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[3] Although not specified in the proposed modification, it has been suggested that these local exhange companies will probably be the twenty-two Bell Operating Companies ("BOCs") now providing local exchange service, perhaps allocated among seven regional holding companies.

IV.

STATE REGULATORY CONCERNS MUST BE A PART OF THE SETTLEMENT

Although we believe that the proposed settlement is not without merit, it is seriously deficient because it perceives the telecommunications industry only in terms of antitrust theory and excludes the vital element of State regulation from the contemplated divestiture process.

It has long been recognized that the local exchange telephone network cannot be efficiently operated under a competitive system. In the interest of technical efficiency, local exchange companies must be operated as regulated monopolies. PUCs, which exist in all fifty States and the District of Columbia, are charged with regulating these local exchange monopolies to assure that universal, efficient, quality telephone service is available at reasonable rates. Central to this scheme of State regulation is the existence of local exchange companies which have sufficient authority, assets and personnel to provide this universal telephone service.

Any divestiture plan approved by this Court will simply direct AT&T to require the BOCs to apply to their respective State PUCs for permission to transfer assets and functions in accordance with the approved nation-wide plan. The PUCs will judge those requests in light of their constitutional or statutory responsibilities to assure the operation of franchised public service companies "in the interest of the public and to promote adequate, economical, and efficient delivery of utility services . . . ." Md. Ann. Code art. 78, § 56. A key element in this process is the determination of "a reasonable return [to the utility company] upon the fair value of the company's property used and useful in rendering service to the public." Md. Ann. Code, art. 78 § 69(a). 4/

Given the massive nature of the proposed reorganization, the task of judging whether the spun-off local exchange companies can provide "adequate, economical and efficient" telephone service and of approving a new rate structure for the new local exchange companies will be extremely difficult under the best of circumstances. Current accounting

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4/ Similar mandates are found in the constitutional or statutory authority of all State PUCs. See, e.g., Ariz. Const. art. XV, §§ 3,14.; D.C. Code Ann. §§ 43-501, 43-601. (1981).

methods employed by AT&T are inadequate for this purpose and have been criticized by many knowledgeable sources. *See, e.g.*, United States General Accounting Office, LEGISLATIVE AND REGULATORY ACTIONS NEEDED TO DEAL WITH A CHANGING TELECOMMUNICATIONS INDUSTRY (1981) at 29-64. The PUCs will thus be faced with the choice of accepting the allocation proposal as presented, including the accounting inadequacies, or rejecting it out of hand. A divestiture which serves the public interest must overcome this deficiency and provide an accounting system which facilitates the fair allocation and evaluation of assets, related debt and tax benefits or liabilities.

State public utility commissions are created by State statutes or State constitutions which clearly empower them to control transfers of assets, functions and discontinuance of services by regulated utility companies. 5/

5/ *See, e.g.*, Md. Ann. Code art. 78, §§ 24(b), 75 (1980); Ariz. Const. art. XV, §§ 2,3,4,5,9,10,12,13 and 14; Ala. Code § 37-1-50 (1975); Colo. Rev. Stat., § 40-5-105 (1973); Del. Code Ann. tit. 26, § 165; La. Const. art. 4, § 21C (1974); La. Rev. Stat. Ann. § 45:1165.1; Me. Rev. Stat. Ann. tit. 35, §§ 104,211,212; Ohio Rev. Code Ann. § 4905.20; Okla. Const. art. 9, §§ 9,18,34; 66 Pa. C.S. § 1102; W.Va. Code § 24-2-12; Wis. Stat. § 196.79 (1979-80).

The clearly articulated, affirmatively expressed State policy requiring actively supervised PUC regulation of local telephone service is not pre-empted by the Sherman Act. California Retail Liquor Dealers Association v. Midcal Aluminum, Inc., 445 U.S. 97 (1978). See Community Communications, Inc. v. City of Boulder, Colorado, 102 S.Ct. 835 (1982); New Mexico Vehicle Board v. Orrin W. Fox Co., 439 U.S. 96 (1978); Bates v. State Bar of Arizona, 433 U.S. 350 (1977); Cantor v. Detroit Edison Co., 428 U.S. 579 (1976). In Parker v. Brown, 317 U.S. 341 (1943), a California statute authorizing a State agency to regulate and set rates for that State's raisin industry was held not to conflict with federal antitrust law. The Court, relying upon principles of federalism, explained:

> We find nothing in the language of the Sherman Act or in its history which suggests that its purpose was to restrain a state or its officers or agents from activities directed by its legislature. In a dual system of government in which, under the Constitution, the states are sovereign, save only as Congress may constitutionally subtract from their authority, an unexpressed purpose to nullify a state's control over its officers and agents is not lightly to be attributed to Congress.
>
> The Sherman Act makes no mention of the state as such, and gives no hint that it was intended to restrain state action or official action directed by a state.

Parker, 317 U.S. at 350-1. Consequently, nothing in a decree entered under the authority of the Sherman Act can override or supplant State PUC regulatory authority. [6]

In short, State public utility commissions are effectively vested with unassailable authority to veto many of the crucial steps of the settlement insofar as they occur within their respective jurisdictions. For example, acting pursuant to its authority to approve or disapprove transfers of regulated functions or assets, a State PUC could decline to permit a BOC to transfer assets, such as customer premises equipment, to AT&T. Indeed, State commissions, acting pursuant to their statutory authority, may require local exchange companies to continue to provide customer premises equipment, internal wiring, a complete classified directory, including the sale of advertising, intrastate interexchange service, and other "competitive" services. Moreover, a State commission could veto the exchange areas proposed by the parties and require the regulated telephone company instead to serve all points within a larger or different calling area. The power possessed by State public utility commissions pursuant to the State action doctrine could, if exercised by some and not by others, result in a balkanized scheme of telecommunications service and effectively frustrate the pro-competitive intent of the proposed settlement.

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[6] The District of Columbia Public Service Commission operates pursuant to express Congressional authority which is not superceded by the Sherman Act. Sabin v. Berglund, 585 F.2d 955, 960 (10th Cir. 1978). Accord Feldman v. Gardner, 661 F.2d 1295, 1308 (D.C. Cir. 1981), petition for cert. filed, 50 U.S.L.W. 3696 (U.S. Feb. 16, 1982) (No. 81-1526).

For these reasons it is critical that the proposed modification recognize the power and responsibility of the States and provide a meaningful role for the States in the reorganization process. The "consultative" role suggested by the Department in its Competitive Impact Statement (CIS at 18) clearly is not sufficient. The States must be given the opportunity to review and comment upon the actual divestiture plan after it has been presented by AT&T and before this settlement is finally approved by the Court. In addition, the proposed reorganization of AT&T must be governed by specific principles to guarantee that, as antitrust policy is carried out, the public interest served by regulation is also protected: (a) the reorganization of AT&T must not compromise universal access to telephone service; (b) the reorganization must be done according to a rational and equitable system of accounting that will permit regulators to account fairly and accurately for assets, debt and tax attributes in the hands of the local operating companies; (c) local telephone companies must retain the ability to offer a classified directory under State regulatory supervision; and (d) AT&T must not receive a windfall for Bell Labs research which was funded before divestiture by license contract payments - ratepayers' money - and which will be funded after divestiture by a research and development cost component in Western Electric's pricing structure.

a. Universal Telephone Service Must Be Preserved

The telephone has achieved a role of unquestioned importance in our society. It connects families separated by great geographic distances. It permits police, fire and medical services to be summoned moments after a need arises. It facilitates commerce between distant points. These functions are vital and must be preserved in any reorganization of AT&T.

The proposed modification, although it will not *necessarily* compromise the goal of universal service, presents a danger to this well settled policy. The proposed modification forbids the local exchange company from providing interexchange toll service or from offering customer premises equipment (except on a limited "emergency" basis). [7] Consumers must depend on AT&T and other companies to compete for these services. While this system will undoubtedly result in competition for interexchange service and CPE sales in lucrative urban areas, there is no guarantee that remote, rural areas will benefit from this competition. Especially with respect to the provision of CPE, the proposed exclusion of the local operating company from this market under the modified decree may eliminate the only economically practicable provider of these CPE services to rural areas.

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[7] There is disagreement as to what may constitute "emergency" provision of CPE. Under the Department's interpretation in the CIS, "emergency services" does not include enhanced "911" services or the provision of "lifeline" CPE to the elderly or the handicapped.

Universal service will also be threatened if the local operating companies do not emerge from divestiture as financially viable entities. Here again, the methodology employed in evaluating the assets to be distributed is a crucial factor in assuring the requisite financial stability. The proposed divestiture must be structured to ensure that the goal of universal service is not compromised.

b. An Adequate Accounting Method Is Imperative

Assets owned by a local exchange company that are "used and useful" in the provision of telephone service are an essential element in the calculation of that company's rate base, upon which consumers' telephone bills are calculated. The process of keeping track of these "used and useful" assets has been made more difficult by the archaic and arcane accounting methods traditionally employed by the BOCs and AT&T. These methods, which are generally based on the retrospective study of broad categories of service, afford the BOCs the luxury of imprecision. The Bell System's preferred cost allocation procedure -- its "Embedded Direct Analysis" -- allocates costs to various categories of products and services only when those costs are considered to be attributable directly to the provision of a particular product or service. For example, the cost of providing subscriber access to the network is obviously attributable to the provision of both interexchange and local service. However, under AT&T's accounting system these costs are deemed "non-allocable" and assigned solely to local exchange service. In addition, Embedded Direct Analysis permits the BOCs to place in their rate base extraneous assets -- known as stranded investments -- which are no longer used or useful in the provision of telephone service. AT&T's outmoded accounting methods make it impossible to assign fairly costs to service provided. A recent General Accounting Office Report supported this conclusion when it noted that the FCC has had great difficulty with the current accounting systems employed by AT&T. United States General Accounting Office, LEGISLATIVE AND REGULATORY ACTIONS NEEDED TO DEAL WITH A CHANGING TELECOMMUNICATIONS INDUSTRY (1981) at 29-136.

Under the terms of the proposed settlement, AT&T and the BOCs have been afforded a unique opportunity to perpetuate and expand their outmoded accounting system. The proposed modification empowers AT&T to determine, subject only to the Justice Department's approval, the allocation of assets, costs and debt. However skillful the Justice Department may be, it simply does not have the personnel to evaluate properly the huge asset, cost and debt re-distribution process which is required by the proposed reorganization within the anticipated timetable. Nor do many State commissions have the tremendous resources required, under the current accounting systems, to make proper asset evaluations, determine whether costs and debt have been properly allocated, oversee asset allocations and institute appropriate administrative proceedings. In short, this herculean task simply cannot be properly accomplished unless the Court requires the parties, at the outset, to employ a rational and equitable accounting system to guide their actions through the reorganization process.

Only an accounting methodology which fully distributes the costs of providing each type of telecommunications service will give the Court and the parties the opportunity to accurately judge the proposed allocations and determine whether the competitive goals of the settlement may be achieved. The Fully Distributed Cost accounting methodology ("FDC") is an example of one accounting approach which can achieve these results. Under FDC, all costs, assets, and liabilities involved in provision of each aspect of telephone service are identified and assigned to the specific classifications of service provided. Under this system, AT&T will be unable to allocate improper depreciation reserves to the local exchange companies thereby creating stranded investments in their respective rate bases. AT&T will not be able to allocate debts and other costs to BOCs which do not properly pertain to the services they will be providing. In addition, any effort by AT&T to continue cross-subsidization after the reorganization, such as by placing with the local exchange companies more than their fair share of the costs of shared facilities which would enable AT&T to lower its prices on competitive equipment, will be readily identifiable.

The FDC accounting methodology has been successfully implemented by many public utilities and such large telecommunications companies as IT&T. In addition, its use has been advocated by the Federal Communications Commission in a 1976 decision, Docket 18128. Use of an FDC-type accounting method will permit the allocation of assets under the reorganization to be scrutinized fully and will allow a smoother restructuring of the BOC network. Most importantly, use of proper accounting methods will greatly simplify the task of the State public service commissions in evaluating asset and debt transfers and establishing appropriate rates in the wake of the settlement. By requiring the parties to employ an equitable accounting method, the Court will encourage State commissions to accept the asset transfer applications which are required under the proposed modification and will facilitate the competitive benefits to be achieved by the reorganization.

c. Local Exchange Companies Must Retain Control Of Classified Directories

Directories are an essential adjunct to use of the local telephone exchange. Indeed, their importance was recognized by the parties in the proposed modified decree, which states that directories are a component of the exchange access function to be performed by the local exchange companies. Modification ¶ IVF. However, in the Competitive Impact Statement (CIS at 29-30) and in public statements made by both parties subsequent to the filing of the proposed modification, it has become clear that the parties intend effectively to remove responsibility for the preparation and publication of classified directories from the local exchange companies. Their justification for this action is their claim that advertising contained in a classified directory is a competitive function. We contend that this interpretation is contrary to the express language of the proposed modification and ignores the realities of directory service.

The classified directory ("yellow pages"), like the alphabetical directory which will remain with the local exchange companies, is an essential device for exchange access. There are many occasions when a consumer seeks to make contact with a business and does not recall the name of the business, or knows that he or she needs a service but does not know who provides the service. These very common instances are the reason classified directories are required by PUCs. Without the yellow pages, the value and quality of telephone service would be diminished greatly. This fact was realized by many public service commissions which, in the early part of this century, adopted tarriffs requiring local telephone companies to publish classified directories. Moreover, the yellow pages serving any given locality carry information that is of particular interest to the people living within that locality. It is thus appropriate to expect that this service should be performed by the local exchange company which has a direct responsibility, supervised by a State regulatory commission, to serve properly the consumers cf the locality. Finally, the sale of advertising in the classified directory, which permits the consuming public to have more complete information than is contained in mere listings, helps defray the costs of providing local service.

These strong justifications for keeping the yellow pages with the local exhange companies override the parties' preferred justification that the yellow pages are "competitive" advertising. Indeed, this contention is erroneous. The yellow pages are, by virtue of their importance to exchange access, a unique medium of communications. When, for example, consumers need a plumber, a rental equipment firm or an exterminator, they do not usually turn to "competitive" advertising media like newspapers, television or radio. They look to the yellow pages. There are no practicable alternative sources for obtaining equivalent access to these consumer services.

The publication of the classified directory cannot be performed competitively. If, as the parties suggest, local operating companies are required to auction off their listings, there will, in the vast majority of cases, be but one bidder - AT&T - for AT&T is the only company that has the capacity to offer a yellow pages currently published by the BOCs on a large scale. Thus, the notion that the yellow pages can be offered competitively is simply incorrect. It is an assumption based on an academic concept of competition that has no empirical basis. In addition, in the event that local exchange companies are required to give up publication of the yellow pages, they may be unable to recoup all the lost advertising revenues by "auctioning off" their lists of telephone numbers. Compare CIS at 29-30. As stated above, as a practical matter there will be only one bidder - AT&T - which raises the danger that it will be able to obtain the list at a bargain rate. Indeed, AT&T may not be obliged to bid at all because it already possesses a current customer list which could be update easily.

In sum, transfer of the yellow pages to AT&T, which will give AT&T a veritable windfall and deprive the local exchange companies of control over an important local exchange access device, is contrary to the language of the proposed decree. The proposal is clearly contrary to the public interest. Accordingly, the Court should disapprove the proposed settlement unless this vital exchange access function is retained by the local exchange companies.

d. Availability of Bell Labs' Research

Bell Labs, jointly owned by AT&T and its subsidiary, Western Electric, has been responsible for, and is still in the process of, the creation and development of numerous technological innovations which have improved and will tremendously improve the quality of telephone service. Much of this research has been funded by many years of license contract payments from the BOCs to AT&T. The money for these payments has, in turn, been paid by consumers. These license contract payments have, in large part, excused AT&T's shareholders from the necessity of bearing the risks associated with research and development and from the need to recoup these costs in the sales price of their products. In short, consumers have bestowed a valuable benefit upon AT&T which will continue to accrue.

The proposed modification recognizes to a limited extent the benefit that has been bestowed on AT&T by local ratepayers. Paragraph IC of the proposed modified decree provides that for a five year period AT&T will provide the BOCs, on a priority basis, all research, development and manufacturing required to enable the BOCs to perform their functions. However, this somewhat cryptic provision may permit AT&T to exact a double payment from consumers by charging local exchange companies a second time for the research already funded by ratepayer contributions through the BOCs' license contract payments. Paragraph IC does not require the provision of research and development at a reduced cost during the specified five-year period to reflect ratepayer contributions nor does the modification recognize generally the value of prior ratepayer contributions. Furthermore, no empirical justification has been presented for the apparently arbitrary five-year period chosen. In light of the "blue sky" nature of much of the research undertaken at Bell Labs, it is entirely probable that ratepayer funded research will not attain a useable status for a much longer period. Thus, if the proposed modification is entered, the ratepayer contribution to this research, and the competitive edge that this funding has given AT&T, will go uncompensated.

Even if AT&T, through Western Electric, could be expected to sell Bell Labs' innovations back to the local operating companies at a competitive price, that price would include a research cost recovery component. Consequently, ratepayers may pay a second time for many innovations. In order to avoid the anticompetitive impact of requiring AT&T to sell to the local operating companies at a below-competitive price, AT&T must continue to be required to license these research benefits on a non-discriminatory basis to all other equipment manufacturers.

The failure to provide for continuing and adequate compensation to local exchange companies for research funded through license contract payments is clearly inequitable and contrary to the public interest. Accordingly, we ask the Court to disapprove the proposed modification unless and until the parties provide either for compensation to ratepayers for the benefit they have bestowed upon AT&T or for non-discriminatory licensing of those research benefits funded by ratepayers through BOC license contract payments.

CONCLUSION

Although the proposed settlement may enhance competition in the telecommunications industry, it is seriously deficient because it fails to address the concerns of State regulatory authorities who must be able to continue to assure consumers of universal, adequate and economical telephone service. These concerns are vital and can be met only if the Court requires the parties to structure the divestiture process according to the principles enumerated in this Joint Comment and retains jurisdiction to supervise all stages of the reorganization process. Further, the Court should withhold approval of the settlement until the detailed reorganization plan has been presented to the Court and has withstood the test of public scrutiny. Only in this manner can the Court be assured that the public interest is protected.

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COMMENTS OF

PAUL L. GIOIA, CHAIRMAN
NEW YORK STATE PUBLIC SERVICE COMMISSION

The New York State Public Service Commission, through its Chairman, Paul L. Gioia, hereby submits comments on the proposed AT&T Consent Decree to the Senate Judiciary Committee. The comments address our major concerns with the Decree, its impact upon the cost of local exchange telephone service and the revisions we feel are necessary to adequately protect the public interest.

We are in general agreement with the underlying intent of the proposed AT&T Consent Decree, namely the separation of monopoly from competitive services in order to prevent cross-subsidies and encourage the development of competition in the telecommunications industry. However, we are troubled by certain provisions of the Decree, specifically those which impose requirements unnecessary to fulfill the antitrust objective of assuring fair competition and others which do not contain adequate safeguards to protect the public interest.

The NYPSC has conducted a preliminary analysis of the Decree and its potential impact upon New York State consumers. The analysis (attached) has led to our conclusion that approval of the Decree, as presently drafted, would not be in the public interest. However, we believe that, with appropriate revisions, the Decree's adverse impact upon local exchange ratepayers can be mitigated while still preserving its antitrust effectiveness. It is our intention to present our views to the District Court and request that the Decree be modified to 1) limit its provisions to only those absolutely necessary to accomplish the objective of the litigation--which is to require the divestiture by AT&T of its local operating companies;

2) clearly state that there is no intention to interfere with the exercise of jurisdiction by state and federal regulatory bodies over those aspects of the implementation of the Decree which would otherwise fall within their jurisdiction; 3) provide for adequate involvement by regulatory bodies and interested parties in the implementation of all other aspects of the implementation of the divestiture plan; 4) take whatever steps are necessary to ensure that the interests of the local operating companies are spearately and agressively protected.

The Decree has a two-part impact upon the cost of local telephone service. The first, which has garnered most of the attention, is the direct or immediate impact due to the restructuring of the Bell System. The second, and perhaps most important, is the long term impact caused by the operating restrictions placed upon the local telephone companies. The long term impact and several areas of direct effect are detailed below.

Western Electric Prices During Transition

We have estimated that New York Telephone's ratepayers could pay over $100 million more annually if Western Electric chose to raise its prices for exchange related facilities to the same levels as its competitors.* Currently, the general trade price levels for this equipment are about 24% above those of Western Electric. During a transition period of several years the operating companies for all practical purposes will remain captive customers of Western. This is because other manufacturers cannot meet operating company demands for equipment without extensive expansion of their manufacturing facilities. During this period, the operating companies are in double jeopardy. First, Western will be free to raise its prices and keep what are essentially monopoly profits for itself, whereas now any such profits are removed from the operating company's rate base. Second, Western will be selling products to the operating companies which the companies paid large sums to Bell Labs and Western Electric to develop through the License Contract.

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*This equates to $1.04 per access line per month.

Under these circumstances, the prices that Western can charge following divestiture should be limited to cost plus the average return earned by similar firms thereby replicating, essentially, the current regulatory practice.

We realize that this approach seems, at first blush, to be anticompetitive on the manufacturing level. It is not, however, since all Western sales to the operating companies would still earn a reasonable profit--they would not be priced so low as to be predatory. Further, the promotion of competition must be balanced against the impact on local telephone rates.

Yellow Pages

The Decree would deny the local Bell operating companies the ability to furnish directory advertising (yellow pages) service. This service has monopolistic tendencies and certainly can be viewed as an adjunct to exchange service than anything else.

This service currently contributes profits of $73 million annually or $.76 per line for New York Telephone. These profits have been used to offset local service costs and, thereby, hold basic exchange rates to a level lower than otherwise.

The Department of Justice indicates that under the provisions of the proposed Consent Decree, telephone companies will be able to maintain all of the current revenue stream simply by selling access to its customer lists and the right to bind yellow and white pages directly together. We believe this point of view is naive. It also neglects the fact that Yellow Page books are already separately bound in the Nation's largest cities -- where most of the profits are derived.

The Decree should be revised to allow the local telephone companies to retain the Yellow Pages operation.

Transfer of Assets

A critical concern in the divestiture process is the establishment of a fair procedure for the valuation of assets removed from the books of a local telephone company. The size of the rate base of a utility is, of course, an overriding concern to state regulators and local ratepayers.

The Decree, in its present form, would leave the details of divestiture to AT&T with Department of Justice oversight. The local operating companies have no individual standing in the process as they will not be independent parties until after the divestiture process is completed.

The terms of the Decree should be modified to require the spin-off of the operating companies intact--even if owned by holding companies as now contemplated--but without any asset transfer. Then the operating companies will be in a position to fight for their own interests on equal terms with AT&T. Only after the assets are valued under an open and fair process should there be any transfers.

Operating Company Capital Structure

A concern closely akin to asset transfer is the capital structure of the local operating companies after divestiture. The possible methods of divestiture are many and at this point we can only speculate as to what AT&T might propose. Divestiture would either take the form of each operating company transferring the non-exchange portion of its business to AT&T (or a subsidiary thereof) or transferring the exchange portion to a new corporate entity which then would become the local telephone company.

Under either basic approach, the local telephone company's capital structure would be affected. At worst, existing long term debt may have to be refinanced at current market rates, an event we estimate would cost New York Telephone an additional $238 million annually or $2.48 per access line per month.

Although the possibility of such extensive refinancing is remote, its existence emphasizes the need for regulatory oversight of the mechanics of divestiture.

The Division Between AT&T and the Local Operating Companies

We understand that parties to the Decree to agree that the divested operating companies may own whatever switching and trunking facilities may be necessary to assemble all of the outgoing traffic from each exchange, and to separate it in response to the access codes of the various interexchange carriers so that it may be presented to them at a point of their choosing. The companies may also own the facilities necessary to receive and distribute traffic destined to terminate in the local central offices of an exchange, and to handle all of the calls which terminate in the same exchange in which they began.

It is clear that the intent of the Decree is to separate the exchange and interexchange functions and to leave the local operating companies in complete control of the provision of exchange services. Clearly, this will require that these companies retain ownership and control of switches which perform the concentration and distribution function at the first level of switching above the local central office. However, these switches are designed as "Class 4" or higher, and the combination of ambiguous wording in the body of the

Decree and certain public statements by Justice Department officials led us to believe that those switches might ultimately reside with AT&T. If this were to happen substantial diseconomies could result as operating companies might find it necessary to construct additional switches to perform this function, and duplicate trunk networks to connect them into their exchange operations.

We now believe that all parties agree this was not the intent of the settlement, and the confusion arose from an imprecise way of defining and describing the demarcation point between the exchange network and the interexchange facilities. Since all parties appear to agree that this switching function should remain with the operating companies, we expect that any necessary clarifications to make that point can be accomplished in the proceeding before Judge Greene.

In another area, however, there does not appear to be agreement among the parties. This relates to the provision in the Decree which prohibits the operating companies from performing any routing of interexchange calls. The Department of Justice Competitive Impact Statement points out that this provision is included in order to prevent the divested operating companies "from reintegrating into interexchange functions". Our concern with this issue stems from the fact that the routing capability is inherent in many local central offices, and in all offices which perform a hierarchical switching function above the local central office. This means that the capability is inherent in nearly all switching units which will be owned and operated by the local operating companies. And, in fact, the routing being discussed here is being performed today in those offices.

If in the future those switches cannot perform the routing function, that capability must be provided as well by the interexchange carrier. While the carrier may wish to provide this function we can see no reason to preclude it from the option of having that service provided by the local operating company at an appropriate cost. In discussing this matter with Justice Department officials, we were told the provision exists to preclude the possibility that a local operating company would tend to favor its long-time parent, AT&T, to the detriment of other carriers. But, we believe that if the service were made available on an optional basis to all carriers at equal rates no such discrimination would take place.

Indeed, requiring other carriers to perform the routing function penalizes them in inverse proportion to the amount of traffic they must switch, since there are large economies of scale in such switching. AT&T, therefore, would benefit widely from the restriction, and the fledgling competitors would be disadvantaged.

Compensation for Prior License Contract R&D Funding

Over the years, nearly half of Bell Labs' costs have been financed through License Contract payments by the operating companies. A portion of these payments covered services of current benefit to the companies, but another protion funded R&D of products and processes which either may be only of future benefit or may be of benefit to the competitive sector of the new AT&T. In either case, the operating companies should be compensated for these past payments. One method of compensation would involve estimating the level of payments and simply paying the operating companies back. Another method would be to provide for licensing of patents granted during this period and returning royalties to the operating companies. Whatever method is used, the principle remains that the operating companies were forced to invest in Bell Labs and are not now in a position to recover that investment without some special provision.

Customer Premises Equipment

The Decree requires the removal of all customer premises equipment from the local operating companies. We agree that this portion of telecommunications is highly competitive and steps are already underway not only to remove it from the local operating companies, but deregulate it as well (FCC Docket 20828 - Second Computer Inquiry).

After thorough consideration of all aspects of the customer premises equipment issue, the FCC concluded that a gradual transition of this operation from the Bell operating companies to a separate subsidiary would best serve the public interest. The Decree would short-circuit the FCC's plan by requiring the immediate transfer of all customer premises equipment.

The immediate transfer may carry with it the immediate loss of the current separations contribution toward exchange costs. Under a recent FCC ruling (FCC Docket 80-286) this contribution would be phased-out over a five year period. Its immediate loss would increase New York Telephone's annual exchange costs by $97 million annually ($1.01 per access line per month) over the level under the FCC phase-out plan.

Restrictions on Local Telephone Companies

Perhaps the most onerous aspect of the Decree is the limitations it places upon the future operations of the local telephone companies. The Decree prohibits the local operating companies from providing any non-exchange telecommunications service that is not a natural monopoly regulated by tariff. It is this limitation that precludes the operating companies from providing directory advertising and may well prevent some services from being provided to the public at all.

This limitation is, in our view, unwarranted and is unrelated to the basic purpose of the antitrust litigation. From AT&T's viewpoint, it guarantees insulation from competition from the best equipped and most knowledgeable group of companies in the field.

"Dial It" Services are an example of the problem. "Dial It" currently produces $23 million in revenues for New York Telephone. Under the Decree, New York Telephone is foreclosed from providing this service. Recent indications are that AT&T does not plan to offer Dial It or Custom Calling II Service--another "information service" or "enhanced service".

In addition to being precluded from providing new and innovative adjuncts to exchange service, the local operating companies may be prevented from using some modern technologies in the provision of basic exchange service. Foremost in this category of operating company restrictions is the use of cellular radio, which has the potential of evolving into tomorrow's method of exchange telecommunications. Here the Decree is unclear, but may well be interpreted as forbidding operating company use of cellular radio.

From DOJ's viewpoint, these restrictions seem to be an attempt to avoid even the possibility of future antitrust violations. We have complete confidence in our ability, and the ability of our sister commissions, in effectively regulating competitive activities by local operating companies so as to prevent any contribution from monopoly service. In our opinion, prompt removal of these restrictions will help the operating companies to arrange financing on better terms, since investor perception of their future would be enhanced. So far, reaction by the financial community to divestiture has been basically negative. Anything that brightens the future of the operating companies will undoubtedly reduce capital costs and ease the pressure on local rates.

The restrictions against providing adjuncts to exchange services should be removed from the Decree. Additionally, cellular radio should be clearly designated as an exchange service provided by the operating companies subject to state jurisdiction as are other exchange services.

Summary

As detailed in the foregoing and in the attached NYPSC staff analysis, the proposed AT&T Consent Decree carries with it the potential for significant adverse economic impact upon local service rates. The large majority of this economic impact can be mitigated by revisions to the Decree, revisions which would not compromise the intent of the Decree. We intend to bring these matters to Judge Greene's attention and attempt to resolve our concerns in that forum.

POTENTIAL IMPACT
OF
MODIFICATION OF FINAL JUDGMENT (CONSENT DECREE)
BETWEEN
UNITED STATES DEPARTMENT OF JUSTICE AND
AMERICAN TELEPHONE AND TELEGRAPH COMPANY
ON
NEW YORK TELEPHONE COMPANY SUBSCRIBERS

PREPARED BY
COMMUNICATIONS DIVISION AND
OFFICE OF ACCOUNTING AND UTILITY FINANCE
NEW YORK STATE DEPARTMENT OF PUBLIC SERVICE

This report has been prepared for the information of the Public Service Commission. Its issuance by the Department of Public Service does not necessarily imply acceptance by the Commission or the Department. The Communications Division and Office of Accounting and Utility Finance are solely responsible for the contents of this report.

FEBRUARY 22, 1982

EXECUTIVE SUMMARY

Potential Impact of The Modification of Final
Judgment (Consent Decree) on New York Telephone
Company Subscribers

Section I. - Background

The New York Public Service Commission has a long history of fostering competition in the telecommunications industry while protecting monpoly customers from subsidizing any anticompetitive tendencies of AT&T or New York Telephone Company. While the Commission and Staff continue to favor competition and deregulation of markets subject to competition, we are concerned that several provisions of the proposed Decree will adversely affect the quality and/or cost of basic exchange telephone service.

Section II. - General Concerns

We question whether the Decree goes too far in setting telecommunications policy in what is basically a two party proceeding based on antitrust law and not on a public interest standard such as is found in the Communications Act of 1934 and similar state statutes.

The Decree appears to reflect some of the provisions of pending legislation (exchange areas) while ignoring other legislative provisions (affordable exchange rates).

Many of the Decree's provisions are imprecise and unclear. The language must be considerably tightened to avoid repetitive requests for interpretation or modification.

The Decree not only goes far beyond legislative and FCC attempts to provide a mechanism to allow AT&T to compete in manufacturing, supplying customer premise equipment (CPE), and offering information services, it restricts Bell Operating Companies (BOC's) from all of these fields and limits them to exchange service and "natural monopoly service actually regulated by tariff". These restrictions on the BOC's are tighter than the 1956 Decree was on AT&T and appear to be unnecessary to accomplish Department of Justice (DOJ) goals.

Section III. - General Financial Considerations of the Decree

There are no guidelines for determining the financial condition of a BOC upon divestiture and no provision for BOC or regulatory input in the reorganization planning process. Under divestiture, New York Telephone should remain as a single entity subject to the regulation of only one state.

No mechanism is specified or referenced in establishing the value of assets to be transferred from BOC's to AT&T. Book value is the implied standard and this standard may substantially understate CPE and interexchange equipment value leaving BOC ratepayers with unfairly high costs.

For the duration of the specified transition period that BOC's are given priority with Bell Labs and Western Electric, prices charged the BOC's should be cost based since BOC's are still largely captive customers.

Restrictions on the scope of permissible operations of BOC's have already created adverse investor perception of BOC's implying higher capital costs. These restrictions can be expected to create demands by BOC's for modifications of the Decree much sooner than AT&T sought modification of the 1956 Decree, unless these provisions are changed now.

The language relating to filing of cost based, unbundled tariffs by BOC's for exchange access imply elimination of current contributions from interexchange service to exchange service rates. Despite reports in the news media by AT&T and DOJ officials to the contrary, it appears that the divestiture of CPE will reduce contributions in support of exchange rates, at least in New York State.

The provision of inside wiring appears to reside with the BOC but in New York this service is not a natural monopoly and should be deregulated. If it is, the BOC's could no longer provide it. Under the logic of the Decree, it should be provided by AT&T.

Cellular radio service provision is not explicit in the Decree. The service appears to resemble monopoly exchange service, even if one additional carrier can provide the service, and hence, the BOC should provide cellular radio service.

Section IV. - Potential Impact of the Decree in New York Telephone's Local Service Rates

The potential impact of the Decree on New York Telephone subscribers is estimated to fall within the following minimum/maximum parameters. Approximately one half of the potential impact is in lost current contributions from inter - exchange service. This area is unclear in the Decree but DOJ and AT&T officials claim the Decree does not preclude a contribution in the access charge. Until this area is clarified, we believe the effect of the potential loss of this large contribution must be recognized.

Item	Annual NYT Impact (in millions) Minimum	Annual NYT Impact (in millions) Maximum	Monthly Impact Per Main Telephone Minimum	Monthly Impact Per Main Telephone Maximum
1. Western Electric purchases	$ 74	$ 100	$0.77	$ 1.04
2. Directory Advertising	73	73	0.76	0.76
3. Administrative Costs	0	152	0	1.58
4. Cost of Divestiture	0	0	0	0
5. Jurisdictional Separations (Interexchange Contributions)	97	626	1.01	6.51
6. Customer Premises Equipment	23	23	0.24	0.24
7. License Contract	0	0	0	0
8. Cost of Equal Exchange Access*	?	?	?	?
9. Cost of Debt and Equity	0	238	0	2.48
TOTAL	$267	$1,212	$2.78	$12.61
Impact as percentage of average Local Service Monthly Rates	40%	182%	40%	182%

Section V. - Operational Considerations

Class 4 Switches which connect the interexchange network to the exchange network apparently are to be owned by AT&T. This is a major mistake. It is an anticompetitive, unequal access arrangement which requires constructing expensive, inefficient, duplicative trunking arrangements to serve multiple interexchange carriers. This provision of the Decree must be changed or some of the major goals of the divestiture plan will be thwarted.

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*Unknown but potentially significant.

The provision of operator services needs to be clarified. BOC's should provide this function for exchange operator services and offer to provide it for interexchange calls to any or all carriers on a nondiscriminatory basis.

Private line service provision under divestiture should follow the same general parameters as exchange/interexchange services.

Language governing provision of CPE for emergencies and provision of coin telephone requires clarification. BOC's should provide all coin telephone service, including the terminal equipment.

Section VI. - Conclusions

We have identified a substantial number of important concerns - both financial and technical/operational - which relate to whether the form of divestiture proposed in the Decree is in the public interest. If the divestiture of the BOC's is ultimately found to be in the public interest, and we are not convinced that it is as currently proposed, many of the problems enumerated in the analysis should be dealt with in the Decree itself. In addition, there appear to be several areas where Federal legislation is needed to establish or preserve important public interest policies - such as maintenance of universal service at affordable rates, fair asset valuation procedures and regulation of the dominant interexchange carrier, AT&T Long Lines, as long as the public interest requires.

Finally, prompt FCC and/or Joint Board actions will be necessary to avoid disruptive transitional effects of the proposed elimination of the separations process and to classify properly inside wiring on customers' premises as a competitive market subject to deregulation on terms similar to those applicable to customer premise equipment.

Potential Impact of the Modification of Final Judgment (Consent Decree) on New York Telephone Company Subscribers

Prepared By
Communications Division and
Office of Accounting and Utility Finance,
Department of Public Service

I. BACKGROUND

For the past decade, this Commission has followed a course of fostering competition where possible in the delivery of telephone services to consumers. Over this period, when we have been recognized as a leader in this respect, we have been able to accomplish the public interest purpose of fostering competition, while protecting monopoly service ratepayers from subsidizing competitive offerings.

The Commission's activities for competition date from 1969 when we first permitted connection of customer-provided equipment to the telephone network through interconnecting devices.1/ In 1972, we ordered a simplified,

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1/ Case 26040 - New York Telephone filing in compliance with FCC Carterfone Case.

relatively inexpensive basis for customers to connect their own equipment to the telephone network of the Rochester Telephone Corporation.[1] We also rejected expensive interconnection devices required by New York Telephone Company to connect recording and answering machines purchased by customers to the New York Telephone Company network in 1976.[2] In 1977, we ordered a statewide equipment certification program which eliminated the requirement for any protective interconnecting device if customer-owned equipment were manufactured to certain quality standards.[3] Shortly thereafter, the FCC adopted a similar Registration Program on a nationwide basis. The following year, in August 1978, the Commission issued a policy statement authorizing retail merchandising of terminal equipment by telephone companies.[4] Accompanying the policy statement was a set of accounting guidelines[5] instructing companies to keep all costs and revenue separate from normal utility accounts, providing an audit trail for rate case or other reviews. In 1980, we extended the customer ownership concept to include wiring on customer premises.[6]

1/ Case 26064 - Rochester Telephone Corporation, Opinion and Order Authorizing Interconnection of Customer-Provided Equipment (NPD) April 21, 1972

2/ New York Telephone - Case 26635, Opinion and Order Directing Direct Connection of Customer Provided Automatic Answering and Recording Devices April 16, 1976

3/ Case 26894 - Opinion and Order Adopting Statewide Liberalized Methods of Interconnection October 25, 1977

4/ Case 27415 - Statement of Policy on Equipment Merchandising Activities by Telephone Companies August 30, 1978

5/ Technical Release No. 12 Class A and B Telephone Utilities July 11, 1978

6/ Case 26894 - Opinion and Order Authorizing Customer-Owned Premises Wiring January 10, 1980

Most recently, the Commission initiated an inquiry into the feasibility of allowing unlimited sharing and resale of telephone services.[1] This inquiry is pending.

Also, in this time period, the Commission looked into the feasibility of deregulating services subject to effective competition. By an order dated August 30, 1978 we initiated such an inquiry with respect to terminal equipment.[2] We found that an entanglement of issues, including our own statute and the cost separations process which allocates costs between jurisdictions, were major stumbling blocks to a unilateral deregulation by New York State. We moved by legislative proposal last year and again this year to remove the statutory prohibitions against deregulating markets which are subject to effective competition and hence no longer in need of comprehensive state regulation.

The new Consent Decree appears to share our overall objectives: it is designed to foster competition in the telecommunications industry and to protect against abuse of monopoly power. In attempting to carry out these basic goals, however, the Decree , as proposed , appears to create other very important problems for the remaining monopoly services. Our analysis attempts to focus on these problems for the purpose of obtaining clarifications or resolutions of them to the end that we may accomplish the basic goal of fostering competition in telecommunications while fully assuring the availability of affordable basic monopoly telephone services as offerings of strong, regulated companies.

1/ Case 27946 - Request for comments regarding: Removal of Telco Tariff Regulations Prohibiting the Resale and Shared Use of Telephone Service March 12, 1981

2/ Case 27415 - Notice Requesting Comments on Proposal to Deregulate Terminal Equipment

II. GENERAL CONCERNS

A. Where National Telecommunications Policy is Made

The Decree, in reality, goes far beyond the more traditional anti-trust role of assuring fair competition in an already competitive unregulated industry. By virtue of the nationwide scope of the Bell System and the public interest nature of the "product" - essential telecommunications services - the Decree is a major force - perhaps too great a force - in determining national public policy in the field of common carrier telecommunications. As a general matter, such broad policy making should come from Congress, where attempts to do so were, in fact, showing signs of nearing fruition. Much of that effort is preempted by the Decree - unless Congress acts to overturn some or all of its provisions. And the direction which the Decree pushes telecommunications policy is a direction predicated largely, if not solely, on the anti-trust standards of Federal Law - not the public interest standards of the Communications Act of 1934 and the similar state statutes throughout the country which set policy for the provision of telecommunications services to the public. In fact, in deciding to agree to divestiture, AT&T officials concede that the direction in which legislative activity was pointing was less desirable - from the AT&T point of view. The legislative inclination was (and is) much more clearly directed toward preserving the basic exchange and interexchange telephone system as an efficient, ubiquitous, and affordable national asset while permitting a mechanism for expanding the Bell System's competitive opportunities than the other way around. A similar approach is being followed by the FCC in its recent proceedings, including most notably the Computer II Docket.

B. The Decree appears to assume some legislative changes already under discussion while ignoring others

The Decree imposed dichotomy of exchange / interexchange closely parallels the jurisdictional boundaries in S898 and those proposed in HR 5158. The Decree even uses virtually the same language as these bills. On the other hand, there is no mention whatever of any concern for or mechanism to assure the affordableness of basic exchange telephone service. On the contrary, the Decree is quite detailed in spelling out requirements for BOC's to file cost-justified, unbundled tariffs for services in a rather short time frame - far shorter than that under consideration in F.C.C. Docket 80-286, for example, where a five-year phaseout of certain cost allocations has been proposed while other allocation changes are yet to be considered.

C. Many Provisions are Unclear

In our own analysis and, according to the news media, everywhere the Decree is scrutinized, there are literally dozens of different interpretations given to important provisions affecting, for example, the equality of access, the availability of mechanisms to keep exchange rates affordable, the specific services and facilities provided by BOC's (or AT&T) and the size of exchange areas. These provisions and others must be clarified in revised, much more explicit Decree language or endless arguments will be left to further arbitration.

D. The Decree appears to give AT&T "all the fun" and the BOC's "all the responsibilities".

Not only is AT&T freed to engage in unregulated manufacturing and the provision of information services heretofore prohibited by the 1956 Decree, it is also allowed to compete for exchange service customers either directly or indirectly by siphoning off large profitable chunks of business for individual corporate customers. As if that were not enough, the BOC's are prohibited from competing with AT&T for anything - not for customer premise equipment, interexchange service, manufacturing, information services (some of which are now being provided by BOC's) or any service not a "natural monopoly service actually regulated by tariff." These strictures are far more onerous for the BOC's than even the 1956 Decree was for AT&T.

III. GENERAL FINANCIAL CONSIDERATIONS OF THE DECREE

Of greatest concern to consumers and state regulatory bodies is the potential impact of the Consent Decree on local exchange rates. This concern arises primarily from the lack of definition and clarity and the numerous interpretations that can be attributed to the many terms and conditions of the proposed Decree. The purpose of the following analysis is to point out those areas of the proposed settlement affecting costs and rates which are unclear and require further amplification, issues that are clear but may have a negative impact upon local exchange consumers, items which are clear and indeed essential, and lastly, those items which have not been addressed by the Decree.

In addition, an estimate of the impact of the Decree on local exchange rates is provided in the following section. It must be borne in mind throughout this analysis that although sharp increases in local exchange service rates could result from the agreement entered into by Justice and AT&T, it is likely that price decreases and new innovations will result in the competitive areas of telecommunications equipment, customer premise equipment and interexchange and information services. These benefits are the ones sought by the Department of Justice. We do not deny their likelihood but we fear the cost to utility service subscribers for these competitive gains may be (1) inadequately considered and (2) potentially too high to justify a finding that the Decree, as proposed, is in the public interest.

A. Terms of the Decree which are clear but objectionable

Section I (A) - It is clear that AT&T must submit to the Department of Justice a plan for and completion of the required reorganization within 18 months after the effective date of the modified judgment. Whether 18 months is sufficient time to enable the completion of such a monumental task is debatable.

There are no guidelines for the financial condition of the BOC's at the time of divestiture and no provision for recourse by a BOC or its regulators if the financial condition is considered unfair or unsatisfactory for any reason. It further appears that the specifics of the reorganization (1) will not be known for six months after the Decree is "entered", (2) will be subject only to DOJ's approval, and (3) will not be subject to comment or modification by outside parties. In New York, it appears that, under a BOC divestiture, it would be in the best interest of New York State telephone subscribers to continue to be serviced by the present corporate entity, New York Telephone (perhaps without the small Connecticut operation), instead of some regional BOC. New York Telephone is in sound financial condition and is already subject to the regulation of only one state, thereby avoiding potential allocation arguments between state jurisdictions. Under these conditions, the operations of a large, stable BOC serving 92% of New York's telephones can best be regulated in the public interest, as a single entity rather than as a smaller piece of a larger whole. No provision is made for formal BOC or regulatory participation in this decision-making process. Full participation should be provided.

No indication is give as to who is responsible for the substantial administrative cost of accomplishing the divestiture. It seems that AT&T shareholders should pay this cost as part of the resolution of the antitrust case they chose to accept. Surely none of this cost should be borne by monopoly ratepayers who allegedly have already been disadvantaged by AT&T to the detriment of AT&T competitors.

Section I (A) (2) - This section deals in part with the separation of assets and facilities between the BOC's and AT&T. No reference is made to the authority of federal and state regulators to determine whether book value, market value or some other valuation standard should be employed in assessing the worth of transferred assets. The Decree seems to imply a book value standard which may significantly understate the value of interexchange and terminal equipment assets leaving BOC ratepayers with unfairly high costs. In addition, the determination of the depreciation reserve associated with each plant account must be made by regulatory authorities.

Section I (A) (3) and Section I (C) - These sections deal with the termination of License Contract and Standard Supply Contract between AT&T and the BOC's. In addition, Section I(C) directs AT&T, Western Electric and Bell Telephone Laboratories to provide to any BOC, on a priority basis, all research, development, manufacturing and other support services as needed. We are concerned, however, that there is no mention that these services should be provided on a cost justified basis. In addition, we are concerned that prior license contract payments by the BOC's for the development of on-going exchange and non-exchange related projects will be considered "water over the dam". Clearly, when BOC's make future purchases from Western Electric, the price of facilities to the BOC's should reflect the fact that a portion of the research and development has already been paid for through license contract expenditures. In the alternative, the BOC's could be reimbursed now for such expenditures. Lastly, there is no provision to assign any of the prior patent rights or to provide for any of the royalty benefits associated with those patent rights to the BOC's. Further, should BOC's be permitted to engage in manufacturing, the BOC's should have access to all patents which existed prior to divestiture. The divestiture as it now stands leaves AT&T with all the goodies and the BOC's holding an empty bag.

Section II (D)(1)(2)(3) - Part D of Section II delineates the activities in which BOC's may engage after divestiture. We find it objectionable that the BOC's are prohibited from providing anything but exchange telecommunications services or natural monopoly service actually regulated by tariff.[1] We have long maintained that either accounting or separate subsidiary safeguards can be implemented and regulatory oversight can prevent cross-subsidies or anti-competitive practices when regulated companies are also engaging in unregulated activities.

The intent of the Decree is to promote competition and so we are at a loss to understand why local telephone companies who have long provided equipment and interexchange services, and who have the expertise to continue to do so, should be denied the opportunity to enter these or other competitive telecommunications or information service fields either through separate subsidiaries or even when integrated into the operations of the exchange corporation along with appropriate accounting safeguards. It is clear that such opportunities, if available to the BOC's, would promote further competition, potentially prevent market dominance by the surviving AT&T company, permit BOC's to grow in the future and avoid the problems inherent in the 1956 Consent Decree which have already denied the public many technological innovations, new services and/or lower prices. All other telephone companies, including many GTE subsidiaries that are larger than some of the BOC's, are permitted into these fields. New York Telephone Company already generates $21 million annually from mass announcement services which it will be forced to give up. Other local exchange oriented services such as those known as Custom Calling II are logically and economically provided by BOC's.

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[1] There is no definition of what natural monopoly telecommunications services are or what happens should such services become competitive.

The restricted markets of the BOC's could also increase the cost of debt and equity capital for them. Several news stories have speculated this result and Moody's Bond Survey of January 12, 1982, hints that at least some BOC's will be downgraded. The investor perception of BOC's is further exacerbated by AT&T's apparent ability to compete with BOC's for exchange services or for services which will bypass the exchange network altogether. In this regard, the BOC's will find themselves in exactly the same predicament which AT&T complains about today -- the 1956 Consent Decree allows competitors into AT&T's business but keeps AT&T out of theirs! Former Assistant Attorney General Philip Verveer observed this problem in remarks reported in the *N.Y. Times* January 25, 1982, as have others.

B. Ambiguous Items Requiring Clarification

Section II (A), Appendix B (A)(1), Appendix B (B)(1),(2),(3) - These sections deal with the question of access charges for interexchange carriers. The sections call for the provision of exchange access on an unbundled, tariff basis that does not discriminate against any carrier or other customer. The access charge tariffs are to replace the division of revenues process and must be cost justified. Any differences in charges to carriers must be cost justified on the basis of differences in services provided. However, Appendix B (B) (3) states that notwithstanding the above that access charges should be equal per unit of traffic delivered or received for all interexchange carriers with minor exception. The meaning and intent of these apparently conflicting conditions are very unclear. Our agreement or disagreement with these terms of the Decree depends heavily on the interpretation associated with each of these sections. We are also unclear as to the parties' (DOJ and AT&T) authority to put these particular parameters into tariffs when normally federal and state regulators determine such matters as a function of the overall public interest.

Specifically, the following items are of utmost concern in assessing potential impacts of the proposed Consent Decree: the meaning of "cost justified"; the meaning of "unbundled basis specifying each type of service, element by element"; whether exchange access charges can include contribution to local exchange services; whether they may do so only until September 1, 1991, as may be provided for in Appendix B(B) (3); whether the FCC regulates the access charges for interstate traffic and, if in doing so, retains jurisdiction over certain BOC costs thereby continuing the need for a jurisdictional cost separations process; and, exactly what constitutes interexchange traffic. We express grave reservations with any plan that would abruptly deprive local exchange rates of the acknowledged contribution currently received through the division of revenues process. The Decree should clearly state what effect, if any, it has or is intended to have on this contribution, both immediately and in the longer run.

Additionally, under the current separations and settlements procedures, a portion of terminal equipment is subdivided between the inter- and intrastate jurisdictions. However, since equipment will no longer be provided by the BOC's, there is no clause allowing the continued contribution to local exchange now available through the separation of terminal equipment. If the current level of contribution can be maintained through access fees and this is clearly stated within the Decree, many of our concerns related to the local exchange ratepayer would be satisfied. However, without clear direction from the Decree, this item is improperly left open to imagination and interpretation.

Section IV (E) - This is the definition of customer premises equipment. It is ambiguous, however, since it does not specify whether inside wiring is included in customer premises equipment. In addition, since it is DOJ's intent to place competitive services with AT&T and since inside wire is competitive in New York, it may be appropriate, under the terms of the agreement, to transfer these costs to AT&T. If, for any reason, it is not transferred to AT&T, the Decree should not require divestiture of this business if it is found by either federal or state regulators to be competitive and/or is deregulated.

Section IV (G) - This section provides the definition of exchange area or exchange. The focus of our concerns is the definition of what comprises an exchange or exchange area; which long distance services will remain with the BOC's; and which services, in turn, will be assigned to AT&T (Long Lines). We have been presented informally with definitions of exchange areas which run from encompassing an entire state to encompassing a single central office. In addition, there is no mention of the treatment of independent telephone companies either for toll purposes, for separations purposes or for inclusion or exclusion from exchange areas.

Depending upon the interpretation of exchange area, such issues as EAS[1/], message unit calling and the opportunity to redefine exchange areas remain in question. Not only is this matter critically important to the local exchange ratepayer, but it also determines which facilities and services will remain with the BOC and which will be transferred to AT&T. It must be clarified.

[1/] Extended Area (Local) Service

C. Terms of the Decree that should be preserved

Section A (1) - This paragraph calls for the establishment of sufficient facilities, personnel, systems and rights to technical information to permit the BOC's to perform independently of AT&T. Clearly, adequate technical expertise and facilities must be available to the BOC's in order for them to function as separate entities. Anything less is unacceptable.

Section A(3) - The license contract agreement should be replaced by cost based charges for services rendered to each BOC. We believe this arrangement is far preferable to the non-auditable relationship between the BOC's and AT&T that exists today and certainly could not be permitted to continue on a divested basis. In that light, the termination of license contract is necessary. The BOC's ability to establish a centralized organization [Section I (B)] for engineering, administrative and other services and thereby replace functions provided by AT&T is a desirable aspect of the Decree.

Section I (C) - The requirement that AT&T, Western Electric and Bell Telephone Laboratories be available on a priority basis to any BOC until September 1, 1987, is a desirable aspect of the agreement. The BOC's are and have been dependent upon the expertise of AT&T. An abrupt termination or lack of availability of these services would clearly not be in the public interest.

Appendix B - There can be no dispute that equal access to the local exchange for all OCC's is a desirable aspect of the Decree. Our reservations focus on the method and cost to subscribers either in exchange or in interexchange rates to accomplish this objective. While we agree with the intent of the proposal, it is difficult without knowing the final cost to be fully supportive of this provision.1/ Lastly, and in the same vein, Appendix B permits the BOC's to bill customers for the use of interexchange services. This is desirable since it will enable BOC's to continue efficient use of their billing and computer systems.

C. Items not addressed

Radio services - Communications services such as paging and mobile telephone service are not addressed by the settlement. Both the terminal equipment and (non-cellular) transmitter facilities of current radio-telephone services provided by BOC's are highly competitive and do not constitute "natural monopoly services". The Consent Decree does not address the disposition of these services. We believe sufficient consumer alternatives already exist in this market and have sought legislation to deregulate currently provided radio-telephone service. Cellular radio telephone service, however, appears much more like exchange service, and it is still likely to

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1/ See further discussion of technical/cost considerations, infra.

exhibit monopolistic tendencies even though there may be two providers. Accordingly, we believe that a firmer definition of the future treatment of radio telephone service must be contained in the Decree. These services should be identified as exchange services, provided by BOC's and not subject to divestiture if and when they are found to be competitive and/or are deregulated by the appropriate regulatory authorities.

Billing for Terminal Equipment - The Decree permits the BOC to provide billing services for interexchange service offered by interexchange carriers. However, it does not permit the BOC to bill, even on an interim basis, for terminal equipment provided to customers of AT&T. NYT has expended millions of dollars in establishing computer billing systems and customer record data base primarily because of the multitude of terminal equipment services. This billing system and computer capacity are intertwined with all other billing information for exchange services. To permit it to become partially idled because AT&T is required to establish a parallel record system would be a waste of resources. This was implicitly recognized by the FCC in its Computer II Order whereby the local operating companies would continue to provide and bill for embedded equipment. The BOC's should be permitted to continue billing of embedded equipment and in turn charge AT&T for a cost-based fee for the service.

D. Other Concerns

Because of the required reorganization, local operating companies may be left with idled facilities and resources. For example, BOC's are currently staffed to process customer orders for complete telecommunication service and include informational or advertising inserts with monthly billing statements. To the extent that the terms of the Decree may cause duplication of these efforts by AT&T or OCC's, the BOC's should be permitted to enter into nondiscriminatory agreements to provide order handling, billing or other services that will utilize fully the capacity and staffing of the local telephone company. To do otherwise is a mismanagement of resources and a waste of consumer dollars.

IV. POTENTIAL IMPACT OF THE DECREE ON NEW YORK TELEPHONE'S LOCAL SERVICE RATES

The divestiture mandated by the Consent Decree and the restrictions placed on a presumed surviving New York Telephone Company will trigger an extensive reorganization affecting the cost levels of every part of its operation. The myriad of possible occurrences and the magnitude of the reorganization mandated by the Decree make it impossible to determine accurately the eventual impact on local service rates. In order to provide an estimate of the overall local service rate impact of the Decree, the major areas within New York Telephone's operation of potential impact were isolated and the impact quantified for each under the most likely scenario. In cases where no clear most-likely scenario could be determined, a range of potential impact was estimated. Unfortunately, there are several such areas.

The major areas of potential impact analyzed are:

1) Western Electric purchases
2) Directory advertising
3) Administrative costs
4) Cost of Divestiture
5) Jurisdictional Separations
6) Customer Premises Equipment
7) License Contract
8) Cost of Equal Access for all OCC's
9) Cost of Debt and Equity

Each of these areas is discussed separately in the remainder of this section. A schedule showing the impact of each item both on an annual total dollar and a monthly per main station basis is attached at the end of the report (Attachment 1).

The primary purpose of the impact analysis is to measure the potential effect of the Decree on New York Telephone's local service rates. Although not directly affected in the same degree, the remaining New York State telephone companies will also experience an impact. The potential impact on the independent companies lies in the toll (interexchange) portion of their business. Currently, the independents are, essentially, in partnership with the Bell System in the provision of toll service, receiving a "settlement" designed to reimburse them for costs incurred in the provision of toll and other interexchange services.

Upon divestiture, this partnership would be dissolved. Instead, each independent would have to negotiate an agreement with each interexchange carrier or file an exchange access tariff, a change which may affect its overall level of toll revenues. Furthermore, the effect of the Decree on jurisdictional separations (infra) may reduce the amount of settlements that each independent might derive through its negotiated agreements or exchange access tariffs.

No estimate of the impact of the Decree on independent telephone companies is included here. However, we do note that many independents derive a significant portion of their revenues through toll settlements. The potential impact upon the local service rates of these companies could be severe. It should be measured, fully disclosed and considered in determining whether the Decree is in the public interest.

No estimate of the cost to BOC's to provide equal access is made because the terms of equal access, as proposed, are onerous and in need of major change. Whatever the cost of equal access, we would expect that cost to be assessed to interexchange carriers through access charges.

WESTERN ELECTRIC PURCHASES

In 1980, New York Telephone Company purchased approximately $706 million in equipment and services from Western Electric, the manufacturing arm of the Bell System. Some $445 million of this amount relates to non-terminal equipment and is representative of the company's post-divestiture annual expenditure levels[1/] and is the amount subject to any divestiture related Western Electric price changes.

A Western Electric price comparison study submitted by New York Telephone Company in its current rate proceeding (Case 27995) before the NYPSC indicated that Western's prices for non-terminal equipment are 19% below the lowest priced equivalent equipment offered by other suppliers. Western Electric could increase its prices to those of its nearest competitors (or even higher) and still remain competitive. Such an increase would raise New York Telephone's equipment purchase costs by 23.5% or approximately $105 million annually (based upon 1980 price and volume levels). Furthermore, since New York Telephone is, in essence, a captive customer of Western Electric for a significant portion of its purchases, Western could raise its prices above the levels

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[1/] New York Telephone would also be able to avoid purchases associated with the portion of its interexchange operation which will be transferred to AT&T. The Western Electric purchases associated with the divested interexchange operation cannot be readily identified but are estimated to be relatively small.

charged by other suppliers.[1]

In the pre-divestiture mode of operation, regulators could guard against such unwarranted price increases by refusing to pass them on to the ratepayers. An excess profit made by Western Electric on sales to New York Telephone could be removed from New York Telephone's earnings. After divestiture, however, this profit limiting mechanism would be lost to the regulators. The equipment purchase costs actually incurred by New York Telephone would have to be recognized unless it could be shown that the company could have purchased its products at a lower price elsewhere.

While it is not known at this juncture what action AT&T will take in regard to Western's prices, it appears possible that prices could quickly rise to at least the level of other suppliers, thereby increasing New York Telephone Company's annual costs by a minimum of $105 million. New York Telephone could not, as a practical matter, purchase elsewhere for a considerable period of time. Thus, the Western Electric profits would still be due to its (prior) relationship and not to its inherent efficiency in a truly competitive market. We suggest that Western's profit on sales to the BOC's be limited to regulated profit levels for the entire period (until September 1, 1987) that priority is given to meeting the needs of the BOC's.

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[1] New York Telephone has little choice but to purchase equipment from Western for its repair and expansion of its existing equipment already purchased from Western.

DIRECTORY ADVERTISING

In 1980, New York Telephone received $146.4 million in revenues from directory advertising ($13.4 million from White Pages advertising and $133.0 million from Yellow Pages advertising). The company had 1980 expenses of $94.5 million for the compiling, printing and distribution of its telephone directories.

Although the Decree does not specifically address the directory operation, it is the widespread interpretation that only the White Pages portion would remain with New York Telephone. The Yellow Page operation would go to AT&T after the divestiture.

The overall directory operation is extremely profitable, with most of the profits coming from the sale of advertisements in the Yellow Pages. The profits have been used to defray the costs of other services provided by the company, with basic exchange service being the primary beneficiary. Loss of any of these directory profits through divestiture would necessitate offsetting local service rate increases.

An exact determination of the profitability of the Yellow Page operation as a separate entity (separate from White Pages) is not available at this point. However, the table below provides a rough division of the 1980 costs and revenues between the Yellow and White Pages.

[$ in millions]

	Yellow Pages	White Pages
Revenues	$ 133.0	$ 13.4
Expense	59.6	34.9
Net Revenues	$ 73.4	$(21.5)

The above breakdown indicates that New York Telephone would lose $73 million annually from the loss of its Yellow Pages business. Some revenues may be obtained by New York Telephone selling its customer lists to any or all bidders. To what extent additional revenues can be expected from this source is unknown.

ADMINISTRATIVE COSTS

Currently, New York Telephone is organized and staffed to perform several administrative functions common to the exchange, interexchange and customer premises equipment (CPE) operations. Upon divestiture of the interexchange and CPE portions of its business, New York Telephone would still be required to perform these administrative functions for its remaining exchange operation.

It is doubtful that the company would be able to shed any appreciable amount of the costs of these functions upon divestiture. That is, it is most likely that the cost of performing administrative functions for just the exchange operation will be nearly the same as performing those functions for all three operations combined.

The largest identifiable administrative function performed by New York Telephone today is its revenue accounting function. The company bills its customers and collects and accounts for revenues received for all three service categories. A portion of the costs are borne by the interexchange and CPE operations, the remainder being paid by exchange users. After divestiture, the entities providing each service will be responsible for their own billing operation. While there may be some decrease in New York Telephone's revenue accounting costs after divestiture, the remaining costs will all be borne by the exchange operation alone. The result would be an increase in administrative costs to the exchange users.

Divestiture will similarly affect other administrative functions such as personnel and public relations. The costs of these functions are currently shared by all three service categories, a sharing that will cease after divestiture. Again, while these functions left with New York Telephone may cost somewhat less after divestiture, the loss of the ability to share these costs with the interexchange and CPE operations would result in increased costs to the exchange operation.

The financial impact of divestiture upon New York Telephone's administrative costs is difficult to quantify and is shrouded in uncertainty by the Decree itself. The Decree allows New York Telephone to continue to provide the billing function for interexchange services after divestiture.[1/] Presumably, New York Telephone will come to some sort of agreement with AT&T and continue to provide interexchange billing. Thus, the company does have the opportunity to mitigate the adverse impact of divestiture by contracting out its already established billing function.

It is uncertain as to the degree and duration of such contract arrangements (AT&T is under no obligation to contract such services with the operating companies) and there is no way of quantifying their impact on the exchange operation. The range of possible impact is estimated to extend from a "best case" of $0 wherein all current non-exchange administrative costs are either eliminated or billed, by contract, to other carriers to a "worst case" of increased exchange costs of $160 million wherein no administrative costs are eliminated and none are billed to other parties.

[1/] The agreement specifically addresses billing for the interexchange operation but is silent on billing for CPE services. It is presumed that New York Telephone will not be allowed to bill for CPE services.

DIVESTITURE COSTS

There most certainly will be additional costs associated with the divestiture itself. These costs (legal, organizational restructuring, creation of new centralized operating company organization, etc.) are of a non-recurring nature and most likely will be incurred over the next 18 months (the maximum time allowed for divestiture).

The NYPSC is currently considering a New York Telephone Company request for increased rates. The rates established in this proceeding will cover at least the April 1, 1982 to March 31, 1983 period and will not include any provision for divestiture costs.[1] Any divestiture costs incurred during this period would, in essence, be paid by the company's stockholders rather than its ratepayers. Since divestiture costs are of a non-recurring nature and will be incurred before mid-1983, such costs would not be included in forecasts of post-divestiture operations and would not affect future rate changes authorized by the NYPSC. Therefore, although divestiture costs may be significant over the near future, it appears unlikely as a practical matter that they will affect exchange rates. As a matter of principle, the cost of divestiture should be borne by AT&T stockholders who agreed to the divestiture plan.

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[1] New York Telephone filed its request long before the divestiture agreement and, therefore, had included no forecast of additional divestiture related costs.

JURISDICTIONAL SEPARATIONS

New York Telephone provides services and facilities that are common to both the provision of exchange services (regulated by the NYPSC) and interexchange services (largely regulated by the Federal Communications Commission (FCC)).[1] The FCC in cooperation with state regulators has established cost allocation procedures used to allocate costs to the interstate (interexchange) jurisdiction. This allocations process is commonly referred to as "jurisdictional separations" or just plain "separations". The current separations procedures allocate a significant portion of New York Telephone's local distribution costs to the interstate interexchange operation. Approximately 30% of the company's costs of hooking up its subscribers to the telephone network (including the cost of customer premises equipment and the lines to the local switching office) are allocated to interstate and are paid for through interstate toll and other revenues. In essence, interstate toll provides a "contribution" toward paying the costs of the local distribution facilities. This contribution has been used by the NYPSC to hold down the price of the basic exchange services under its jurisdiction.

With growing competition in both the customer premises equipment and interexchange markets, the FCC, in cooperation with State regulators, is taking steps to modify the current separations procedures to accommodate competition. One proposal, which is expected to receive FCC approval, will phase out the interstate allocation of customer premises equipment over a five-year period beginning January 1, 1983. Additionally, the prognosis is that the interstate allocation of the remaining local distribution costs will be significantly reduced in the future. The effect of these changes is a gradual transfer of costs from the interstate to the intrastate jurisdiction. In other words, customers will pay these costs in their monthly basic exchange rates rather than in toll charges.

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[1] The NYPSC regulates interexchange communications that originate and terminate within New York State. Interexchange communications that cross state lines are regulated by the FCC. The interstate portion of interexchange represents the lion's share or approximately 70% of the total for New York Telephone.

The Decree apparently will accelerate these separations changes and cause more rapid increases in local service rates. The word "apparently" is used here because of the ambiguity of the Decree. It may well be the case that the Decree will have no effect upon separations. However, it is the apparent intent of the Decree to eliminate the allocation of local distribution costs to the interexchanges services.

The impact of the Decree upon separations can be divided into two segments - 1) customer premises equipment and 2) non-CPE local distribution.

- Customer Premises Equipment -

As discussed previously, the current separations proposal is to phase out gradually the interstate allocation of customer premises equipment costs over a five-year period beginning January 1, 1983. The Decree, however, requires the divestiture of all CPE within 18 months. It is logical to conclude that the interstate allocation of CPE costs must cease concurrently with the elimination of CPE from the company's operations.

In terms of 1980 cost levels, the elimination of the interstate CPE allocation would reduce the interstate contribution by $120.8 million and, thereby, cause an equivalent basic exchange service rate increase. Since this contribution most likely would be phased out even in the absence of the Consent Decree, the Decree can only be held responsible for the acceleration of the phase-out. In the first year of divestiture an average of $24.2 million would be lost under the anticipated phase-out. The Decree would cause the entire $120.8 million to be lost in the first year, or an increase of $96.6 million over the phase-out plan.

Non-CPE Local Distribution -

In 1980, New York Telephone allocated $679.2 million of local distribution costs to interstate in addition to the interstate allocation of CPE costs. As discussed above, this level of contribution most likely will be significantly diminished through future FCC separations changes. However, such a reductioh would most likely be spread over many years and have only a gradual impact upon local service rates.

The Decree, in essence, does away with the separations process as it now exists. Instead of allocating costs to interstate and recovering them through a share of interstate revenues, New York Telephone would directly bill interexchange carriers (including the divested AT&T interexchange carrier) for use of its exchange facilities through a series of "access charges". The Decree requires that these access charges be "cost justified" and be separately stated (unbundled) for each exchange access service provided to each interexchange carrier.

The specific reference to "cost justification" is interpreted as a prohibition against the continuation of the current separations method which is largely predicated upon a judgmental allocation process and is not supported by an underlying "cost justification". Thus, it appears that the existing annual contribution level of $679.2 million would not be allowed to continue.

The "best case" situation would be the continuation of the contribution at existing levels (requiring a most liberal interpretation of "cost justification"). The "worst case" would be the loss of all but a modest portion of the contribution. Under the worst case, it would still be reasonable to charge for exchange access at the same rate now paid by business exchange users, namely timed message service. It is estimated that these charges would generate $150 million annually, thereby reducing the contribution loss from $679.2 million to $529.2 million.

CUSTOMER PREMISES EQUIPMENT

The Decree mandates the removal of customer premises equipment (CPE) from New York Telephone's operation. The CPE portion of the business would be run by AT&T after divestiture.

The impact of New York Telephone's loss of its CPE business on local service rates is a function of CPE revenues and costs. If the CPE revenues exceed CPE related costs, the loss of the business would adversely impact the remaining operation. Conversely, if CPE services were priced below their costs, the loss of CPE would benefit the remainder.

The NYSPSC has striven to price New York Telephone's CPE services above their embedded average costs, using the higher current cost levels as a benchmark in pricing.1/ While the relationship between CPE revenues and costs change with time due to changes in the current to embedded average costs relationship and other factors, it appears likely that CPE rates would continue to be set above average embedded costs. Based on the CPE rate levels recently recommended by the Administrative Law Judges in the current New York Telephone rate case before the NYPSC, it is estimated that divestiture of the CPE operation would cause a net contribution (revenues in excess of costs) loss of $22.6 million annually.

1/It should be noted that total company or unseparated costs are used in setting CPE rates. The separations related interstate contribution due to CPE is not used to offset CPE rates but is instead used to lower basic exchange rates. The impact of the potential loss of this CPE related interstate contribution is addressed separately in the discussion of jurisdictional separations.

LICENSE CONTRACT

New York Telephone Company paid its parent, AT&T, $113.6 million in 1980 for services rendered under an agreement commonly called the "License Contract". The payments are for advice and assistance from AT&T's General Department ($79.6 million) and for basic research and systems engineering work ($34.0 million) performed by Bell Laboratories, the research arm of the Bell System.

The divestiture agreement calls for the termination of the License Contract and allows for the creation by the remaining operating companies of a centralized function similar to the current General Department of AT&T. Additionally, the operating companies would be permitted, on a contract basis, to continue their relationship with Bell Laboratories. Thus, it seems likely that the savings accruing to New York Telephone by the elimination of the License Contract will be offset by the costs of the new centralized organization and the Bell Labs contracted services.1/.

Divestiture would eliminate the opportunity for AT&T to pass along to the operating companies expenditures upon non-operating company operations (e.g., enhanced service development). It could be surmised, then, that divestiture

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1/The total magnitude of expenditures after divestiture would be lower since many of the current functions (e.g., terminal equipment) would no longer be necessary. However, the operating companies would also be smaller perhaps resulting in the same proportionate level of "License Contract" expenditures.

would result in savings to the operating companies by eliminating any existing subsidization of AT&T's costs of developing non-utility competitive services.

The issue of subsidization through the License Contract has been addressed by the NYPSC in New York Telephone rate proceedings. The Commission has found these subsidizations to exist and has removed these costs from those passed on to the company's ratepayers. While divestiture would eliminate these subsidizations, the impact upon the ratepayers would be minimal since these costs have already been removed through ratemaking adjustments.

COST OF DEBT AND EQUITY

The net impact of divestiture upon New York Telephone's cost of capital is a function of the changes in its capital structure (i.e., debt - equity ratio) and the cost of capital (i.e., the cost of both debt and equity).

In setting New York Telephone's allowed rate of return on its net investment, the NYPSC historically has used the Bell System consolidated capital structure and capital costs. Upon divestiture, consolidation can only be used to the extent that New York Telephone is part of an affiliated group of operating companies.1/ Thus, divestiture most likely will have an effect upon the capital structure used in ratemaking by the NYPSC. There are too many uncertainties at this point to estimate the probable impact of capital structure changes.

Capital costs also will be influenced by the divestiture. Equity costs and the cost of new debt would be dependent upon a myriad of presently unknown variables including the organizational and capital structure of the Bell operating companies and the investors' perception of the risks associated with the exchange business. No estimate of the probable effect upon these items can be made at this point.

1/At this point it is uncertain whether New York Telephone will be separately owned, part of a regional holding company or part of a system-wide holding company.

A correlative capital cost issue related to the Decree is its impact on the existing (embedded) cost of debt. Currently, New York Telephone has many issuances of long term debt outstanding, some with annual interest rates below 3%. The composite cost of outstanding debt is 7.3%. It is a distinct possibility that some portion of this debt will have to be redeemed (and, perhaps, reissued) as a result of the reorganization of New York Telephone. Refinancing of all outstanding debt would double the company's annual interest costs, an annual increase of approximately $250 million.

For the purposes of this analysis, a range of $0-250 million is used as an estimate of the potential increase in capital costs for New York Telephone. It should be kept in mind, however, that this estimate is highly speculative, a situation necessitated by the broad range of possible organizational structures for the operating companies.

V. - OPERATIONAL CONSIDERATIONS

A. Equal Access

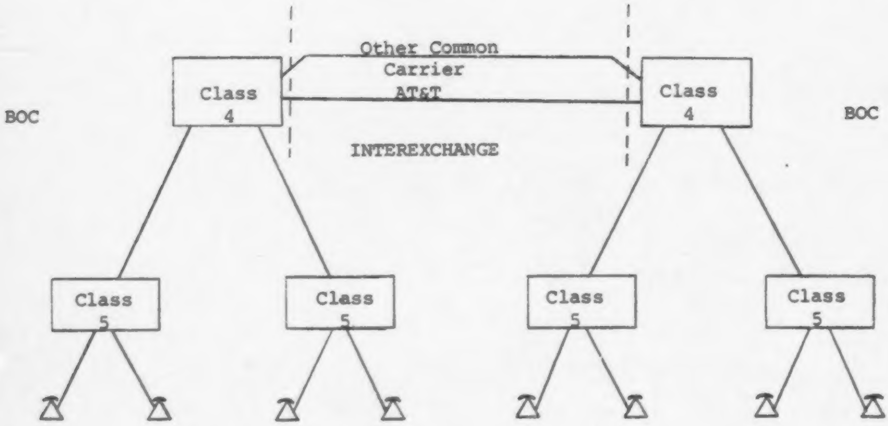
1. Ownership of the "Class 4" Switching Offices.

The language of the Decree raises substantial questions in regard to the ownership of the "Class 4" switching office. Some preliminary comments are in order to help clarify the problem.

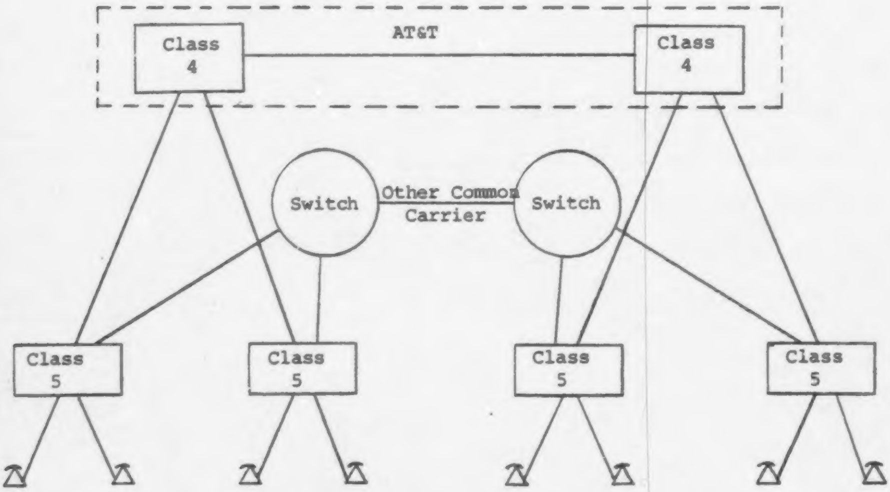
Traditionally, a "Class 4" switching office is a network switching point at which traffic originated by customers in the "Class 5" end offices is concentrated and delivered to trunks which carry that traffic to the rest of the world. Similarly traffic to an exchange from the world is delivered to the "Class 4" point and distributed to the "Class 5" end offices and the customers served by those offices. The "Class 4" switch establishes a connection between trunks from end offices in the exchange, and trunks that ultimately go to another exchange. (See Figure 1).

The situation is clouded by the fact that "Class 4" operation is provided in switches which also perform other switching as well. There are many installations where both the "Class 4" and "Class 5" local switching functions are contained in one machine. There are also many locations where the "Class 4" function is combined with "Class 2" or "Class 3" toll network functions in the same unit. Thus, in most cases, it will not be possible to separate out and identify the hardware which represents the "Class 4" machine. We are assuming that for the purposes of the Decree the term "Class 4 Switch" is intended to mean the switch at which interexchange traffic is transferred from the interexchange carrier to the BOC, and vice versa.

FIGURE I


Other Common
Carrier
AT&T
BOC
Class
4
Class
4
BOC
INTEREXCHANGE
Class
5
Class
5
Class
5
Class
5

Access Arrangements if
BOC Owns Class 4 Switch


Class
4
AT&T
Class
4
Switch
Other Common
Carrier
Switch
Class
5
Class
5
Class
5
Class
5

Access Arrangements if AT&T Owns Class 4 Switch
Trunks and Switching Facilities Duplicated

At the present time, most BOC's use switches in larger exchanges to route local traffic from one "Class 5" end office in the exchange to another "Class 5" end office in the same exchange. There are economic efficiencies in such an arrangement, in that the same amount of traffic can be carried on fewer combined use trunks than would be required if the intermediate switch point were not used. Under the reorganization called for in the Decree, such intermediate, or tandem, switching capability will have even more application, because the exchange areas are defined as larger than they are today.

Section IV, Para. F, of the Definitions in the Decree states: "Exchange services for exchange access shall not include the performance by any BOC of interexchange traffic routing for any interexchange carrier." The term "routing" is defined by James Holmes in Communications Dictionary as the "process of determining and prescribing the path or method to be used in forwarding messages." We read these passages to mean that the BOC is prohibited from performing any switching function at the interface between the BOC and the interexchange carrier, the "Class 4" office. We find this situation to be costly and inefficient from the standpoint of both the BOC and the interexchange carriers.

If we assume, as the Decree requires, that existing "Class 4" switching points which perform this interface function will belong to AT&T, the BOC has no physical point at which to offer equal access to its exchange network for other carriers except in the Class 5 end offices. This would require the construction of additional trunks from each end office to the other carrier's location, duplicating the trunk field already existing to serve AT&T traffic. It would also mean that local tandem switching heretofore performed in some of these interface switches ("Class 4/5") could only continue to be performed there after execution of some form of lease agreement with AT&T, or additional trunking and perhaps tandem switching equipment would have to be provided by the BOC.

A fundamental principle of telephone engineering is that a single large trunk group is a more efficient way to carry a given amount of traffic than several small groups. The language of the Decree appears to require that existing, efficient trunking arrangements in the local exchange must be broken down into smaller, less efficient trunk groups. It also means that while AT&T would have access to the BOC's local exchange network at a single efficient point where the BOC's will deliver trunks to an AT&T switch, the other carriers will have inefficient access only at the end offices and will have to provide (or pay for) the new trunking and any switching (which would duplicate existing trunking and switching) necessary to get there. This type of "equal" access makes no sense whatsoever.

Also, operator services do not appear to be addressed directly in the Decree, and the provision of these services is tied directly to the problems associated with the "Class 4" switching offices. Operator services today are generally provided by a mechanized system called TSPS (Traffic Service Position System), which is directly connected with the trunks at the "Class 4" switch. If this switch were transferred to AT&T, the TSPS operator system and function logically would have to go with the switch to AT&T. But this would leave the BOC without any operator capability, although it would still have to deal with local exchange access and emergency assistance calls. While the operating problem could be solved either with some form of operating agreement with AT&T, or by having the BOC provide a new (duplicative) local operator unit, the most sensible solution seems to be to leave the existing operator function with the BOC where it has the ability to provide local assistance and also offer operator services on an equal basis to all interexchange carriers. Similar concerns apply to the Directory Assistance operator service, since access to these operators is accomplished through the "Class 4" switch.

We are mindful of the purpose of the Decree to separate the local exchange monopoly service from the competitive interexchange business with equal access provided by the BOC to all interexchange carriers. Strict interpretation of the language of the Decree, however, appears to require an unnecessary duplication of trunking between "Class 5" end offices and local tandem switching points, and may require construction of additional, unnecessary local tandem switching points to provide "equal" access for interexchange carriers other than AT&T. Such construction would create additional costs for both the BOC's and the interexchange carriers (other than AT&T) probably running into several hundreds of millions of dollars nationwide.

Attempting to define the interface point between the interexchange carriers and the BOC's as being at the exchange side of the interface switch (The "Class 4") as the Decree apparently does results in costs and complexities which are totally unnecessary, are a detriment to telephone users, and contribute nothing to the anti-trust goal of cost efficient equal access.

Such a division will virtually preclude the provision of "equal access" for all carriers, since AT&T will have access via its embedded "Class 4" switch and the BOC's embedded trunks to that switch, while access for all other carriers will be provided with new trunk facilities and perhaps new "Class 4" type switching equipment. The costs and, therefore, the rates for access using this new investment would be higher than for the use of embedded investment, placing the other carriers at a competitive disadvantage. In addition, cumbersome leasing agreements would be necessary between the BOC's and AT&T for the provision of such functions as operator services, and there would be the probable incurrence of huge costs by both the BOC's and the interexchange carriers for facilities which unnecessarily duplicate those already in place.

The public will ultimately pay those costs through its payments for toll and local telephone service.

A far better solution is to define the interface point as the intertoll trunk side of the switch which performs the Class 4 function, and let ownership of the switch (the "Class 4") at the interface rest with the BOC's. [1/] In this way, the BOC's can continue to engineer and operate the local exchange network in the most efficient manner, and the BOC's can provide equal exchange access to all carriers. Duplicative facilities will be minimized, and the need for complex operational and financial agreements will be eliminated along with the disagreements as to interpretations and the lack of precision which they would generate. The objectives of the Decree would be met, and the public's total payments for telephone service would be minimized. The current provisions, if we are properly reading them (New York Telephone personnel read them as we do), are simply a bad mistake that must be corrected.

2. Phased in Equal Access Provisions

The requirement for equal customer access to all carriers by a uniform access code will result in the introduction of a 3 or 4-digit code in place of the existing single digit now used for toll access. The cost implications of such an arrangement are significant. In stored-program switching machines, a translation modification will be necessary to recognize and deal with the new codes. Additional registers will be necessary to accommodate the increased dialing time for interexchange calls. And, in electromechanical switching

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[1/] We recognize that some switches which provide the Class 4 function also provide switching functions at a higher level in the network hierarchy.

units, the existing registers themselves will have to be replaced or modified, since they cannot now accept a 13 or 14-digit number.

In switching machines other than electonic stored program-controlled, even greater rearrangements and costs may be incurred. It is true that the Decree suggests equal access may not have to be provided in some of these machines, but the escape from this requirement appears to be limited to machines serving fewer than 10,000 lines, or where excessively high costs for rearrangement would be incurred and, in any event, this escape clause can be overturned by an appeal to the Decree Court. Since interexchange carriers would appear to have a strong interest in wide availability of equal access, we would anticipate a number of such appeals to the Court. In addition, there are a number of locations in New York State where exchange service is provided by Crossbar switching equipment serving more than 10,000 customers, and there are a few locations where Step-by-Step switching equipment serves more than 10,000 lines. Although these units will eventually be replaced with electronic switches, the pressures arising from demands for equal access could lead to premature retirement of otherwise productive investment, or expensive modifications of obsolete equipment.

We are particularly concerned that all of the costs associated with the provision of equal access be charged to the interexchange carriers and not to the local exchange subscriber. These costs will include provision of additional equipment to handle the traffic requirements of 2 or 3-digit access codes; costs associated with any necessary office modifications; and costs associated with premature retirement of existing units.

B. Customer Contact Complications

Under the proposed structure, a customer may deal with AT&T for terminal equipment (and perhaps inside wire), the BOC for exchange service, and either AT&T or another carrier or both for interexchange service. The customer may be required to deal with each of these organizations separately to obtain the service and will have to coordinate installation. The same condition will hold with regard to repair. If the customer cannot determine which component is faulty, he will have to coordinate troubleshooting and repair efforts with the various organizations providing the components of service. This is clearly a negative aspect of divestiture.

Our experience leads us to believe that the equipment provider, the local exchange carrier and the interexchange carrier, may not have a great incentive to cooperate with one another in the coordination of effort to provide for repair service. In fact, they will likely "pass the buck" frequently as the BOC already does with customer premise equipment vendors or radio-telephone companies.

This condition may give rise to outside brokers or agents who undertake to provide coordination to customers for a price, and it will likely cause increased customer complaints with regulatory agencies in an effort to compel compliance at no direct cost to the consumer. In either event, service to the customer may be diminished, and, at least indirectly, the customer will pay for these coordination efforts or breakdowns. In permitting competing carriers to offer terminal equipment or interexchange services without requiring divestiture, a customer could opt to cope with these problems or to avoid them by continuing to use only one carrier - a benefit of the vertically integrated structure.

C. Emergency Services

Section II (BOC Requirements) Para. D(2) prevents the BOC from manufacture or provision of telecommunications products or customer premises equipment except for provision of customer premises equipment for emergency services. Emergency services are not defined. It is possible that the BOC would need only to maintain a supply of telephones for use in case of a disaster. At the other extreme, the BOC could be required to provide premises equipment on an ongoing basis to public safety agencies, not just at the time of a disaster. In either event, the BOC must maintain a stock of equipment and an associated installation and maintenance expertise on this equipment.

There appears to be little reason to allow or require the BOC to provide customer equipment for emergency use except to insure the availability of this equipment at the time of a disaster. Customer premises equipment of all types and for all uses has been considered to be competitively supplied by unregulated entities or soon to be deregulated entities (under FCC Computer II).

Public safety agencies can and do provide their own telecommunications equipment for ongoing use. It is only during a disaster that someone, (presumably the BOC) other than public safety agencies should have available a supply of customer premises equipment to support existing emergency communication arrangements. This is in the public interest.

Limiting the definition of emergency services provided by a BOC to that of a disaster condition would limit the costs to the BOC of this function and prevent them from entering an essentially competitive era.

Also, on the subject of emergency service, it is questionable whether, under the Decree, the BOC would be allowed to provide all of the Enhanced 911 (E911) service features currently contemplated for BOC supply. This service normally requires a separate processor in a processor controlled central office (ESS or digital) to perform the Automatic Location Identification (ALI) function and to provide the office processor telephone number transfer information, so that automatic routing from and to an emergency report center is possible. The Automatic Location Identification feature could be viewed as an information service under the Decree. Because the BOC is restricted to provision of information access and cannot be a provider of information services, it may not be able to provide Automatic Location Information.

It may be possible to construe the Decree to allow ALI by a BOC if the ALI function is considered to be a directory service, since BOC's are allowed to provide directory service. The decree should be clarified to allow the BOC to provide ALI.

D. Private Line Services

The Decree is silent on these services. In the worst case, the BOC's could be denied from providing them in any form, which would result in the provision and unnecessary duplication of many existing essentially local facilities by others. In the best case, private line services would be considered to follow the definitions of exchange and interexchange telecommunications service.

We believe the BOC's should be able to provide private line services between points within the BOC's exchange areas. In addition, the exchange facilities for an interexchange private line would be provided by the BOC on a non-discriminatory basis and the interexchange portion of the circuit would be provided by AT&T or other carriers.

F. Coin Telephone Service

The Decree is silent regarding the provision of coin telephone service. We presume that the only reasonable interpretation is that public coin service should be provided by the BOC, and that this should include provision, installation, and maintenance of the coin telephone, as well as necessary central office facilities.

The situation regarding sem-public coin telephone service is less clear. Semi-public service is a subscriber requested service carrying a monthly charge. The coin telephone is installed on private property, generally at the request of the property owner, to meet a need experienced by the owner.

In many instances, the coin line is also equipped with an answer-only (no dial) extension, for use by the property owner. If this service is to be provided by the BOC, it appears to conflict with the prohibition regarding provision of customer premise equipment. If provided by others, there are problems with collection of the revenues from the coin box. If the service is eliminated, a customer need is not served.

The language of the Decree should be modified to permit the BOC to provide all coin telephone service.

VI. - Conclusions

We believe we have identified a very substantial number of important concerns - both financial and technical/operational - which relate to whether the divestiture proposed in the Decree is in the public interest. There are probably many more to be found given more time. We intend to continue our analysis.

If divestiture is ultimately found to be in the public interest, and we are not convinced that it is, many of the problems enumerated in the analysis can and should be dealt with in the Decree itself - either as clarifications of intent or as changes are in the public interest. In addition, there appear to be several areas where Federal legislation is needed to establish or preserve important public interest policies - such as maintenance of universal service at affordable rates, fair asset valuation procedures and regulation of the dominant interexchange carrier, AT&T, as long as the public interest requires.

Finally, prompt FCC and/or Joint Board actions will be necessary to avoid disruptive transitional effects of the proposed elimination of the separations process and to classify properly inside wiring on customers' premises as a competitive market subject to deregulation on terms similar to those applicable to customer premise equipment.

Attachment
Page 1 of 2

ESTIMATED IMPACT OF CONSENT DECREE UPON LOCAL SERVICE RATES OF NEW YORK TELEPHONE COMPANY

The following table shows an estimate of the impact of the Consent Decree on New York Telephone's local service rates for each of the major areas of potential impact discussed in the report. A range of estimated impacts is shown for each area on both a total annual revenue and a monthly per main station basis. In cases where a most-likely impact could be estimated, that figure is used as both the minimum and maximum amount. The minimum amounts shown assume the continuance of current proportional allocation of exchange costs to the interstate jurisdiction (approximately 30%) wherever applicable. The maximum amounts assume that current interstate allocations would be reduced to 5%, the worst case wherein interexchange access charges are limited to timed local message rates.

Attachment
Page 2 of 2

SUMMARY OF ESTIMATED IMPACT OF CONSENT DECREE UPON LOCAL EXCHANGE RATES OF NEW YORK TELEPHONE COMPANY

	Impact Area	Annual Impact on Exchange Rates ($ in millions)		Monthly Per Main Station Impact on Exchange Rates	
		Minimum	Maximum	Minimum	Maximum
1.	Western Electric Purchases	$ 74	$ 100	$ 0.77	$ 1.04
2.	Directory Advertising	73	73	0.76	0.76
3.	Administrative Costs	0	152	0	1.58
4.	Cost of Divestiture	0	0	0	0
5.	Jurisdiction Separations	97	626	1.01	6.51
6.	Customer-Premises Equipment	23	23	0.24	0.24
7.	License Contract	0	0	0	0
8.	Cost of Equal Exchange Access 1/	?	?	?	?
9.	Cost of Debt and Equity	0	238	0	2.48
	TOTAL	$ 267	$ 1,212	$ 2.78	$ 12.61
	Impact as % of Average Basic Monthly Local Service Rates	40%	182%	40%	182%

1/ Unknown but potentially significant.

Attachment
Page 2 of 2

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	TOTAL	$ 267	$ 1,212	$ 2.78	$ 12.61
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FEDERAL EXPRESS

Federal Express Corporation
Box 727
Memphis, Tennessee 38194

901 369-3600

April 5, 1982

The Honorable Strom Thurmond
Chairman
Committee on the Judiciary
United States Senate
Washington, D.C. 20510

Dear Senator Thurmond:

These comments are submitted on behalf of Federal Express Corporation in conjunction with the hearings held on March 25, 1982 by the Senate Judiciary Committee concerning the ramifications of the proposed settlement of the United States' antitrust suit against AT&T. Federal Express appreciates this opportunity to comment on events which will surely constitute a highly significant chapter in the history of U. S. telecommunications policy.

Federal Express supports the current efforts of the legislative and executive branches of the Federal Government to promote competition within the telecommunications industry. Competition will encourage increased investment and thereby stimulate the development of advanced products and services.

While Federal Express believes that the settlement's proposed restructuring of AT&T may produce salutary results, it also wishes to express concerns relating to several aspects of the settlement. Federal Express commends the prudence of the Judiciary Committee in undertaking, through these hearings, a careful review of the potential impacts of this far-reaching settlement action.

Federal Express' concerns with the settlement fall into two categories. First, it is not certain that the particular restructuring upon which the settlement is premised will insure continued growth of competition in the telecommunications industry. Second, this restructuring may have an adverse impact upon large users of Bell System services.

In addressing the first concern, Federal Express notes that the settlement would free AT&T from the shackles of the 1956 consent decree and allow its entry into the provision of unregulated communications and data processing products and services. The potential for underpricing these new products and services and thereby injuring present and future competitors would persist even after severing of the ties between AT&T and its local operating companies. This is due to the immense market power which AT&T would retain, after the settlement, in the provision of long-distance services. AT&T now controls over 95 percent of the long-distance market. The Judiciary Committee is doubtless aware of the possibility for diversion by AT&T of "monopolistic" long-distance revenues in order to price its new products and services at less than their true costs.

Thus, the attention currently riveted upon divestiture of Bell's local operating companies may obscure the fact that this action, in the absence of other safeguards, may not preserve or enhance the prospects for a strong and diverse group of companies which seek to meet the telecommunications needs of the American public. Federal Express is concerned that this potential peril not be minimized by the Congress.

Federal Express' second concern, with the settlement's impact upon large users of Bell System services, is based upon direct experience: our payments to AT&T and its operating companies will exceed $26 million during the 12-month period ending May 31, 1982. The airline industry as a whole is heavily dependent upon telecommunications services. With recent deregulation, this industry has become highly competitive. The availability of high-quality telecommunications services at reasonable rates is thus of vital importance at a time when several major U. S. passenger carriers are in danger of business failure. Significant increases in telephone rates or deterioration in service could have a drastic effect on these and other carriers.

Our specific concerns about the effects of the restructuring upon users are summarized below:

(1) Rate Increases for Local Exchanges and Private Data Lines

Dramatic rate increases for local exchanges and private data lines could result from the restructuring. A number of sources, including officials of Bell System operating companies, have indicated that the proposed restructuring of AT&T will accelerate increases in local exchange rates. Business users have already absorbed significant increases in such rates during the past 12 months, and with little prior warning. Additional substantial increases in local rates would aggravate other problems faced by industry in the current economic climate, and alternate means of local distribution are not currently available. The recent statement by the FCC endorsing the Bell operating companies' pursuit of additional business activities beyond basic telephone service, will cause them to raise rates to provide the necessary funds for such ventures.

(2) Uncertainty Regarding Access Charges

The settlement would create a system of access charges to replace the existing separations procedures for the division of toll revenues between intrastate and interstate carriers. It is uncertain whether Justice and AT&T have authority to do so, since the FCC and 50 public utility commissions have jurisdiction over establishing access charges, depending on whether the access is for interstate or intrastate service. Charges could thus be widely-varying and bear little relation to cost. Moreover, AT&T retains a virtual monopoly over long-distance services; few viable alternatives exist at present. While satellite service provides some competition to AT&T Long Lines, this leaves more for local area networks within cities and states. Costs to Federal Express alone could exceed $2.5 million dollars over the next 12 months.

(3) No Provision for Access by Private Systems or for Interconnection of Exchange Telecommunications

The terms of the settlement make no provision for access to the local exchange facilities of the Bell System operating companies by private interchange telecommunications, such as private microwave links. The only item specified to date is local exchange interconnection for inter-exchange common carriers and information service providers. Nor is provision made for the interconnection of exchange telecommunications to the local exchange facilities of the Bell operating companies. Thus, a large segment of telecommunications users could receive less than fair treatment.

(4) Viability of Operating Companies

The settlement drastically limits the services which the local operating companies may offer and transfers much up-to-date equipment to AT&T. Unless the Bell operating companies are funded with sufficient low-interest-rate debt and endowed with sufficient non-obsolete capital equipment, local telephone service could deteriorate and substantial increases in user rates could occur. Even worse, the operating companies might be forced to enter the debt market seeking new funds for capital improvements at a time of high interest rates, sparking increases.

(5) Coordination of Service to Users With Nationwide Needs

Today, Federal Express receives the attention of a Bell national account team to coordinate service by 22 Bell operating companies throughout the U. S. Despite efforts of this team, there are still significant and frequent interruptions in our vital telecommunications service. Dealing with seven independent companies and AT&T Long Lines to coordinate nationwide service without the aid of this team will be costly. It must be noted that this team is now provided by AT&T under existing rate structures. Losing this support will mean less service for more money.

In summary, it is crucial that time be taken to implement whatever structural changes are finally approved. A transitional period should be considered during which service rates are frozen, cost structures are established for access and for each telecommunications service, private user equipment access rates and policies are established, the asset base and financial structure of the operating companies are defined on a rational basis, and serious harmful impact to the American industrial economy is avoided.

We at Federal Express are confident that the Committee will examine these and other issues in its assessment of the terms of the settlement, and will seek to foster the shared goals of insuring competition and the availability of communications products and services at reasonable rates. Federal Express stands ready to provide the Committee with any further information it may seek.

Sincerely yours,

Charles D. Winston /wns

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Vice President
Network Systems